CEIOPS-DOC-52/09

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

Assessment of Group Solvency

(former CP 60)

October 2009

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1. Introduction

1.1. Background

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.

1.2. This Paper provides advice for the Level 2 implementing measures referred to in Article 234 of the Solvency II Level 1 text[1] (herein "Level 1 text"). Article 234 refers to the technical principles and methods set out in Article 220 to 229 and the application of Articles 230 to 233.

1.3. The scope of this advice includes therefore elements related to the scope considered to assess the group solvency (221, 225, 226, 227, 228, 229) and the calculation methods of the group solvency (220, 222, 223, 224, 227, 230, 231, 232, 233). The last set of articles include the calculation of the group SCR, either with the accounting consolidation-based method or the deduction and aggregation method, and the assessment of available elements of own funds, including the fungibility and transferability of own funds. The advice also addresses issues related to third country entities and/or groups.

1.4. In this advice, for the purpose of mutual groups, combined accounts should be used instead of consolidated accounts.

1.2. Group solvency assessment in QIS 4

1.2.1. Approaches tested in QIS 4

1.5. From April to July 2008 CEIOPS conducted the fourth Quantitative Impact Study on Solvency II (QIS4). Groups were extensively tested for the first time. However, it should also be noted that the group data were in general subject to more caveats than the solo data.

1.2.2. Main findings regarding group solvency assessment in QIS4

1.6. The main findings regarding group solvency assessment in QIS4 can be summarized as follows:

- Diversification effects varied considerably from one group to another and depended strongly on the individual group structure. However, with an

[1] Latest version from 19 October 2009 available at http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf

average diversification effect of 21 percent, the effect appeared significant;

- Diversification effects were greater for larger groups than for smaller groups;
- The calculation of group excess own funds under the Solvency II QIS 4 assumptions showed a slight increase compared with Solvency I;
- The study found that further work is needed on transferability of assets, especially in relation to diversification effects, elements stemming from third countries and the with-profits parts of insurance groups;
- Not enough groups reported data for group internal models to compare the group SCR assessed with the standard formula and a "current" internal model.

1.7. This paper takes into account the results and comments from the QIS4 exercise in developing a Level 2 framework for group solvency. It also addresses some of the main valuation difficulties that were expressed on particular areas of QIS 4.

2. Synopsis of Level 1 Text

2.1. The Level 1 text sets out in Article 234 that:

The Commission shall adopt implementing measures specifying the technical principles and methods set out in Articles 220 to 229 and the application of Articles 230 to 233 to ensure uniform application within the Community.

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 301(3).

2.2. These provisions should be read in connection with Recitals 95 to 116 of the Level 1 text.

2.3. The following paragraphs provide a brief synopsis of the main topics and features covered by articles 220 to 233 that are addressed in subsequent chapters of this paper.

2.4. **Article 220** details the choice of the calculation method for the group SCR. The Accounting Consolidation-based method is the default method. The group supervisor shall be able to require, after consultation with the other supervisory authorities in the college and the group itself, the use of the deduction-aggregation method or a combination of both methods when the default method is not appropriate.

2.5. **Article 221** deals with the interpretation of the concept of the "proportional share" of related undertakings to be included in the calculation. This includes the recognition of solo solvency deficits at group

level and includes an explicit power for the group supervisor to set the proportional share in some cases (dominant or significant influence determined by the supervisory authorities and absence of capital ties). The absence of capital ties often refers to mutual undertakings.

2.6. **Article 222** ensures there are no double use of own funds and addresses the eligibility of own funds at group level taking into account potential availability constraints.

2.7. **Article 223** ensures that the intra-group creation of capital is eliminated when calculating group solvency.

2.8. **Article 224** states that the valuation principles that apply at solo level also apply at group level. It allows Member States to use the solvency figures calculated in other Member States.

2.9. **Article 225** ensures that all related (re)insurance undertakings are included in the group calculations.

2.10. **Article 226** accounts for the inclusion of intermediate insurance holding companies in the group calculations.

2.11. **Article 227** details the equivalence assessment process for third country regimes for the purposes of the deduction and aggregation method.

2.12. **Article 228** accounts for the treatment of related credit institutions, investment firms and financial institutions when calculating group solvency and allows their inclusion (via methods 1 and 2 described in Annex 1 of the financial conglomerates directive 2002/87/EC) unless their deduction is decided by the group supervisor.

2.13. **Article 229** provides for the deduction of the book value of a related undertaking if the information necessary for calculating the group solvency of its participating undertaking is not available.

2.14. **Article 230** describes the default method for the group calculations, the Accounting consolidation-based method, including the minimum consolidated group SCR.

2.15. **Article 231** describes the approval process for a group internal model and the application of a solo capital add-on in the context of a group internal model. The approval process for a group internal model is covered in the advice on the the approval of an internal model[2].

2.16. **Article 232** deals with the application, when the consolidation method is used, of capital add-ons at group level. That advice includes the description of issues related to group specific risks. The setting of a capital add-on at group level is covered in CEIOPS advice on capital add-ons[3].

[2] CEIOPS-DOC-28/09 (October 2009), see http://www.ceiops.eu//content/view/17/21/
[3] CEIOPS-DOC-49/09 (October 2009), see http://www.ceiops.eu//content/view/17/21/

2.17. **Article 233** describes the deduction and aggregation method for the group calculations, including the imposition of a capital add-on to the aggregated group SCR..

3. Advice

3.1. Definition of group for the purpose of assessing group solvency

3.1. Some of the advice in this paper may need to be adjusted or refined to take account of the reviews of other financial services directives. For example, this may affect CEIOPS advice on the entities that fall within the scope of group supervision for assessing group solvency.

3.2. In general, the scope of group for the purpose of assessing group solvency will be the same as the one of the consolidated accounts. Indeed, this will limit the burden of both supervisors and groups. This applies also to the assessment of dominant and significant influence. Nevetheless, there might be cases where it might be necessary to adjust the scope or the assessment of influence. Those cases are explained below.

3.1.1. Definition of group for the purpose of assessing group solvency

3.3. According to recital 96 of the Level 1 text, group supervision should take into account insurance holding companies and mixed-activity insurance holding companies to the extent necessary. However, it does not imply that Member States are required to apply supervision to those undertakings considered individually.

3.4. According to recital 97 of the Level 1 text, whilst the supervision of individual insurance and reinsurance undertakings remains the essential principle of insurance supervision, it is necessary to determine which undertakings fall under the scope of supervision at group level.

3.5. Article 212 (1) states that:

3.6. *"group supervisor means the supervisory authority responsible for group supervision, determinded in accordance with Article 247."*

3.7. Article 235 states that:

"where insurance and reinsurance undertakings are subsidiaries of an insurance holding company, the group supervisor shall ensure that the calculation of the solvency of the group is carried out at the level of the insurance holding company applying Articles 220(2) to 233. "

3.8. Article 220 states that:

"*the calculation of the solvency at the level of the group of the insurance and reinsurance undertakings referred to in point (a) of Article 213(2)*

shall be carried out in accordance with the technical principles and one of the methods set out in Articles 221 to 233."

3.9. Therefore, CEIOPS considers it is important to clarify the scope for the purpose of assessing group solvency. The definitions used in title III of the Level 1 text are found in Articles 13 and 212.

3.10. Article 212(1)(c) states that:

"group" means *a group of undertakings that*

(i) *consists of a participating undertaking, its subsidiaries and the entities in which the participating undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship as set out in Article 12(1) of Directive 83/349/EEC; or*

(ii) is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, and that may include mutual or mutual-type associations, provided that:

one of those undertakings effectively exercises, through centralised coordination, a dominant influence over the decisions, including financial decisions, of the other undertakings that are part of the group; and

the establishment and dissolution of such relationships for the purposes of this Title are subject to prior approval by the group supervisor;

where the undertaking exercising the centralised coordination shall be considered as the parent undertaking, and the other undertakings shall be considered as subsidiaries;

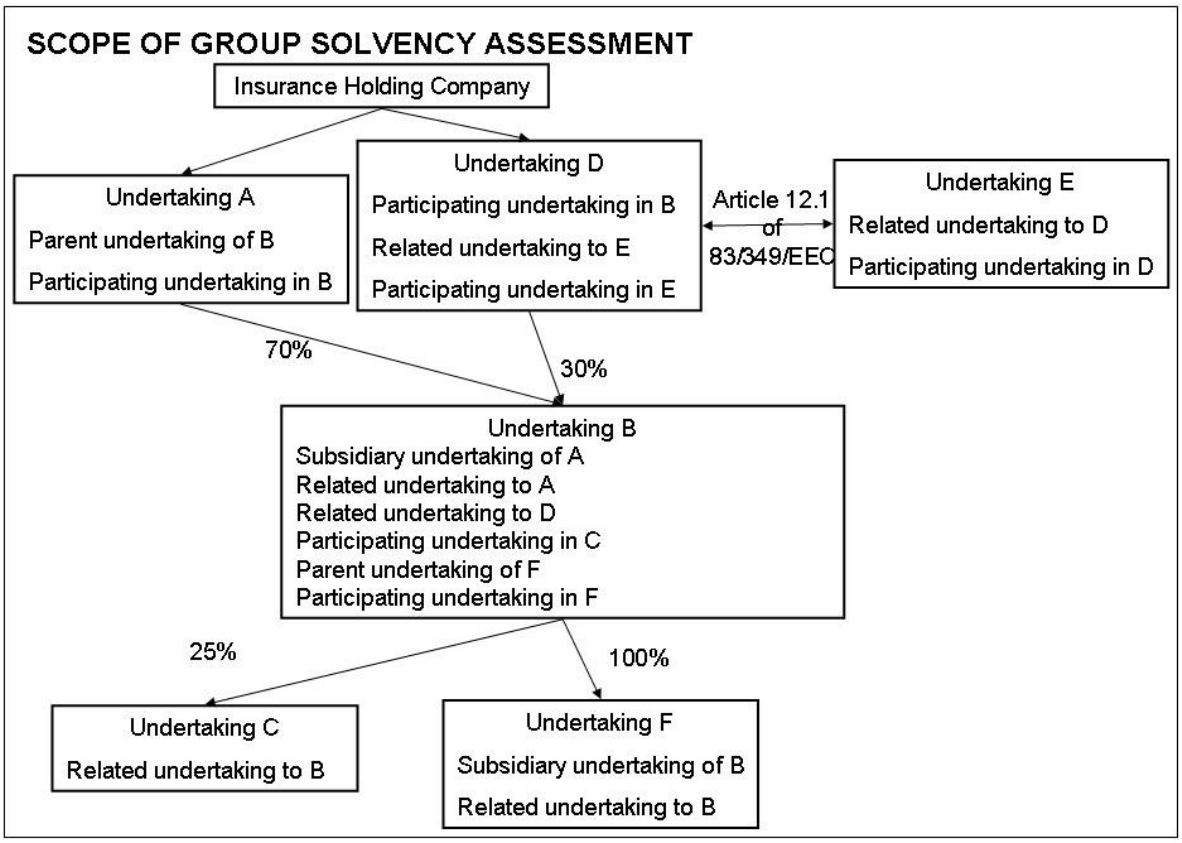
3.11. Article 13(18) defines the relationship between a parent undertaking and a subsidiary undertaking as set out in Article 1 of the Directive 83/349/EEC (see Annex 3).

3.12. For the purposes of assessing group solvency, 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 subsidiary undertaking any undertaking over which a parent undertaking effectively exercises a dominant influence (Article 212(2)).

3.13. The level 1 text, like the Insurance Groups Directive 98/78/EC (IGD), specifically includes the concept of dominant influence.

3.14. "Participation" means the ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking (Article 13 (20)). For the purpose of assessing group solvency, the supervisory authorities shall also consider as participation the holding, directly or indirectly, of voting rights or capital in an undertaking over which a significant influence is effectively exercised.

3.15. The following graph illustrates the entities that have to be considered when assessing group solvency:



3.16. Article 214(2) states that the group supervisor may decide on a case-by-case basis not to include a (re)insurance undertaking in the group supervision referred to in Article 213, for the purpose of assessing group solvency, in the following cases:

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 229;
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 (of article 214) they must nevertheless be included where, collectively, they are of non-negligible interest. (…)

3.17. CEIOPS considers that the principle established through the different definitions and articles is that all parts of the group necessary to ensure a proper understanding of the group and the potential source of risks within the group have to be included within the scope of group supervision for the purpose of assessing group solvency.

3.18. CEIOPS notes that similar issues concerning the scope of the group and the treatment of participations are being dealt with as part of the Financial Conglomerates Directive (FCD) review being undertaken by the Joint Committee on Financial Conglomerates (JCFC). The FCD review focuses on definitions, scope and internal control requirements, and how these areas and implementation may impact on the fulfilment of the objectives of the FCD.[4]

CEIOPS' advice

3.19. In general, the scope of group for the purpose of assessing group solvency will be the same as for the consolidated accounts. Indeed, this will limit the burden of both supervisors and groups. Nevetheless, there might be cases where it might be necessary to adjust the scope of the group for assessing group solvency.

3.20. CEIOPS considers that all parts of the group necessary to ensure a proper understanding of the group and the potential sources of risks within the group have to be included within the scope of group for the purpose of assessing group solvency.

Mutual or mutual-type associations

3.21. According to Recital 98, mutuals and mutual-type associations, subject to Community and national law, are able to come together by constituting concentrations or groups. Those groups are mostly not constituted with capital ties but through formalised strong and sustainable relationships, based on contractual or other material recognition that guarantees a financial solidarity between the mutuals or mutual-type associations.

3.22. As mentioned above, Article 212(1)(c)(ii) states that:

"group" means a group of undertakings

(ii) that is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, and that may include mutual or mutual-type associations, provided that:

- *one of those undertakings effectively exercises, through centralised coordination, a dominant influence over the decisions, including financial decisions, of the other undertakings that are part of the group; and*

- *the establishment and dissolution of such relationships for the purposes of this Title are subject to prior approval by the group supervisor.*

[4] http://ec.europa.eu/internal_market/financial-conglomerates/docs/200804-cfa_en.pdf

Where the undertaking exercising the centralised coordination shall be considered as the parent undertaking, and the other undertakings shall be considered as subsidiaries.

3.23. Where a significant or dominant influence is exercised through a centralised coordination, the mutuals and mutual-type associations shall be supervised according to the same rules as those provided for groups constituted through capital ties in order to achieve an adequate level of protection for policyholders and a level playing field between groups.

3.24. CEIOPS views centralised coordination within the meaning of Article 12(1) of the Directive 83/349/EEC.

3.1.2 Definition of dominant influence and significant influence

3.25. According to Article 221(2) :

"The group supervisor shall determine, after consultation with the other supervisory authorities concerned and the group itself, the proportional share which shall be taken into account in the following cases:

(a) where there are no capital ties between some of the undertakings in a group;

(b) where a supervisory authority has determined that the holding, directly or indirectly, of voting rights or capital in an undertaking qualifies as a participation because, in its opinion, a significant influence is effectively exercised over that undertaking;

(c) where a supervisory authority has determined that an undertaking is a parent undertaking of another because, in the opinion of the supervisory authority, it effectively exercises a dominant influence over that other undertaking."

3.26. The assessment of dominant and significant influence should be consistent as much as possible with the one in the consolidated accounts. Nevetheless, as foreseen in Level 1 text, there might be cases where supervisors assess influence for the purpose of supervision of groups, which may result in some adjustment to the scope. .

3.27. For the purpose of assessing group solvency, the main characteristic of a parent-subsidiary relationship is control. Undertakings are usually controlled by means of a holding in voting rights or capital in the subsidiary.

3.28. As mentioned above, Article 13(18) defines the relationship between a parent undertaking and a subsidiary undertaking as set out in Article 1 of the Directive 83/349/EEC (see Annex 3).

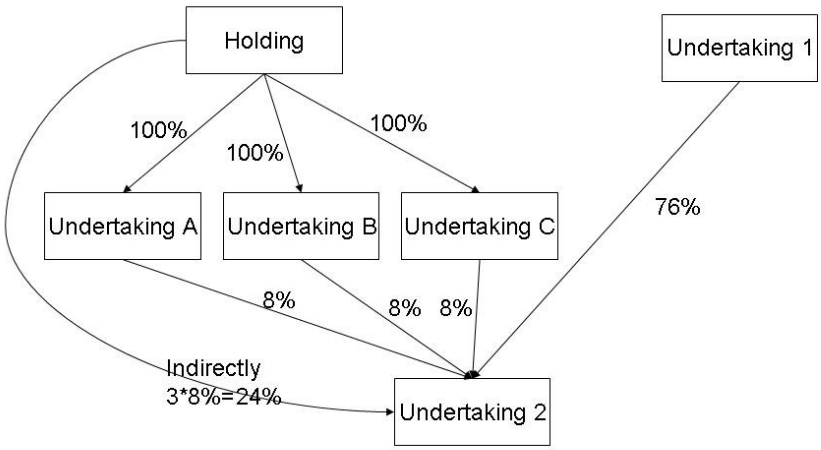
3.29. This Article includes a range of situations in which an undertaking has a majority of the shareholders' voting rights in another undertaking (a subsidiary undertaking), including the right to exercise a *dominant influence* over the management on a unified basis.

3.30. According to Article 212(2) an undertaking should also be considered as a subsidiary if, in the opinion of the supervisory authorities, a dominant influence is effectively exercised by its parent undertakings. Under the same article, an undertaking should also be considered as a related undertaking if a significant influence is effectively exercised by its parent undertakings.

3.31. Therefore there is a need for group supervisor, after consultation with other supervisory authorities concerned and the group itself, to check if the concept of control used for the establishment of the statutory consolidated accounts is consistent with the level 1 text. A dominant influence may exist for the purpose of assessing group solvency, but not for the establishment of the statutory consolidated accounts.

3.32. It must be noted that the assessment of dominant influence could have a direct impact on the membership of the college of supervisors as, in that case, the entity will be treated as a subsidiary and the supervisory authority responsible for the subsidiary will become a member of the College in accordance with article 248(3) if the subsidiary is in the EEA.

3.33. A holding of 20% or more of the voting rights (directly or indirectly) will indicate significant influence. If the holding is less than 20%, the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated. This significant influence has also to be assessed when several intermediary levels exist.



3.34. If two or more entities are subject to the significant influence of a parent, owner company, investor, or common officers or directors, those entities shall be considered as related parties with respect to each other.

3.35. Significant and dominant influence is usually evidenced in one or more of the following ways:

- representation on the board of directors or equivalent governing body of the investee;
- participation in the policy-making process;
- material transactions between the investor and the investee;
- interchange of managerial personnel;

- provision of essential technical information;
- management on a unified basis;
- potential voting rights (e.g. exercise of warrants).

3.36. A change of dominant influence or significant influence represents a significant economic event that changes the nature of an investment. In the case of a loss of dominant influence, the entity is no longer considered as a subsidiary undertaking.

CEIOPS' advice

3.37. The assessment of dominant and significant influence should be consistent as much as possible with the one in the consolidated accounts. Nevetheless, as foreseen in Level 1 text, supervisors may need to assess influence for the purpose of supervision of groups, which may result in an adjustment to the scope of the group.

3.38. CEIOPS considers that significant and dominant influence is usually evidenced in one or more of the following ways:

- representation on the board of directors or equivalent governing body of the investee;
- participation in the policy-making process;
- material transactions between the investor and the investee;
- interchange of managerial personnel;
- provision of essential technical information;
- management on a unified basis;
- potential voting rights.

3.1.3 Treatment of participations in the calculation of the group SCR

3.39. The treatment of participations at group level should be based on the following criteria:

- the classification and method of the participation should be based on economic principles and not merely on legal grounds. Control and influence should always be assessed firstly at group level to establish the significance of the participations. This ensures that situations where several entities of a group have small participations in the same undertaking are not overlooked.
- in line with the principle above, the consolidation approach used for accounting purposes should be used for solvency purposes to the extent they are based on economic principles suitable for a solvency assessment.
- the choice of the method should be made under the proportionality principle as per Article 29.

3.40. The regulatory consolidated accounts is the consolidated position of the group taking into account any necessary adjustment referred to in Article 228 and Article 229 and any other measures taken by the group supervisor that may adjust the scope of the group.

3.41. Regulated financial entities with capital requirements should be included in the group calculation using the deduction and aggregation method when it is not appropriate to include them through the consolidated accounts. This is to ensure there is no circumvention of the sectoral rules. In principle, when assessing the aggregated group SCR, capital charges on intra-group transactions should be eliminated. However, CEIOPS considers that further work may be done at level 3 in order to avoid arbitrage and any unintended consequences from a prudential point of view when applying the deduction and aggregation method.

3.42. One particular area of relevance in the review of the FCD for insurance group supervision is the identification of participations and the concept of 'durable link'.[5] While 'durable link' is not a concept in the Level 1 text, the issue is related to the identification of significant influence in determining a parent-participation relationship. The lack of a clear definition of 'durable link' and its potential inconsistency with IAS 28 guidelines on significant influence has resulted in MS interpreting the concept differently, creating some variance in the application of conglomerate supervision. CEIOPS notes that the JCFC is considering ways to promote a more consistent cross-sectoral approach to the treatment of participations, including the development of guidance material.

3.43. The JCFC is also assessing the impact of where the inclusion of participations is a trigger for the identification of the group as a financial conglomerate. The JCFC is also analysing the impact of the different treatment of participations. The experiences of the different treatment of participations at group level for financial conglomerates is relevant to CEIOPS as it develops its approach for participations at both solo and group level.

Consolidation methods for (re)insurance undertakings and reinsurance special purpose vehicles[6]

3.44. CEIOPS considers that the statutory accounting balance sheet should be used as the basis for consolidation. The starting point for solvency purposes, where International Financial Reporting Standards apply, may have to be adjusted to account for changes in international accounting standards. Since 1 January 2005, European listed companies have had to publish, as a minimum, consolidated financial statements based on the new International Financial Reporting Standards (IFRS) rules.

3.45. The proposed treatments of participations for the calculation of the group SCR according to the Accounting consolidation method is in line with the international accounting standards (see for the comparison the table in Annex 5).

3.46. Entities which are part of the regulatory group but excluded from the accounting group must be consolidated in any case for regulatory purposes (method 1) or they should be taken into account using the deduction aggregation method (method 2).

[5] Article 17, Directive 78/660/EEC.
[6] As regards the treatment of SPV at solo level see CEIOPS-CP-36-09.

3.47. Where a participation in (re)insurer is regarded as a dominant influence this will imply a full integration of the participation in the accounts or a proportional integration (if there is jointly shared control of the participation). In the case of a fully integrated participation, minority interests would in turn contribute to cover part of the group SCR (see section 3.4.3). The same treatment applies to an SPV over which dominant influence is exercised.

3.48. Where a participation in a (re)insurer is regarded as significant influence, the contribution to the group SCR should be calculated as the group's share in the participation multiplied by the solo SCR of this participation. This is consistent with the equity method consolidation where such participations are accounted for at equity value in the group's consolidated accounts. Participations where significant influence is exercised shall contribute to the group SCR in the sum of respective share's in each individual SCR, calculated as referred above in this paragraph. If the solo SCR of the current year is not available, then as a proxy the previous SCR should be used, adjusted for the annual development of premiums for non-life business and technical provisions for life business. For the first year, Solvency I data could be used.

Related credit institutions, investment firms and financial institutions

3.49. Article 228 states:

> *"When calculating the group solvency of an insurance or reinsurance undertaking which is a participating undertaking in a credit institution, investment firm or financial institution, Member States shall allow their participating insurance and reinsurance undertakings to apply mutatis mutandis methods 1 or 2 set out in Annex I to Directive 2002/87/EC. However, method 1 set out in that Annex shall be applied only if the group supervisor is satisfied as to the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The method chosen shall be applied in a consistent manner over time.*
> *Member States shall however allow their supervisory authorities, where they assume the role of group supervisor with regard to a particular group, to decide, at the request of the participating undertaking or on their own initiative, to deduct any participation as referred to in the first paragraph from the own funds eligible for the group solvency of the participating undertaking."*

3.50. Regulated asset management companies which are subject to EU capital requirement under MiFID/CRD/UCITS are covered under Article 226.

3.51. The treatment of the other financial regulated entities should be consistent with the Financial Conglomerate Directive (FCD).

3.52. The calculation methods set out in the annex 1 of the FCD do not consider a possible diversification between sectors and prescribe the use of sectoral rules. The rationale behind is that there are different requirements for different financial entities.

3.53. Therefore, the group solvency of the insurance group would reflect the combination of the own funds and solvency requirements of the insurance and non-insurance undertakings based on the relevent sectoral rules (subject to the calculation method applied).

3.54. In the case of financial non-regulated undertakings, a notional solvency requirement should be calculated[7].

Institution for occupational retirement provision (IORP)

3.55. According to recital 138 of the level 1 text:

> *'Article 17(2) of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision refers to the existing legislative provisions on solvency margins. Those references should be retained in order to maintain the status quo'*.

3.56. Similar to credit institutions, investment firms and financial institutions, IORP undertakings are subject to the relevant sectoral rules. Therefore, potential diversification benefits between IORP undertakings and other entities within groups should not be considered.

Insurance holding companies and mixed activity insurance holding companies

3.57. According to recital 96, "*Such group supervision should take into account insurance holding companies and mixed activity insurance holding companies to the extent necessary. However, this Directive should not in any way imply that Member States are required to apply supervision to those undertakings considered individually*."

3.58. CEIOPS considers that controlled insurance holding companies should be consolidated, that is a full integration of the participations in the intermediate insurance holding company and in the insurance undertakings participated by the insurance holding company.

3.59. An insurance holding company has to be included in the scope of the regulatory group to prevent downstreaming of lower quality capital items as higher quality capital to regulated subsidiaries. Any material risk in holding companies should be addressed.

3.60. As insurance holding companies can be established in a different jurisdiction than the parent undertaking, cooperation between supervisors is of utmost importance.

Non-regulated non-financial entities

[7] Notional solvency requirements means the capital requirement with which a financial non-regulated entity would have to comply under the relevant sectoral rules as if it were a regulated entity of that particular financial sector (see Annex 1 of Dir 2002/87/EC).

3.61. As a general principle, participations in entities outside the financial sectors (both dominant and significant influence) should be consolidated through the equity method. Treatment in the group SCR should then be consistent with the treatment in the solo SCR[8].

3.62. Only the ancillary entities[9] that are subject to a dominant influence should be consolidated through a full integration of the participation in the accounts. Ancillary entities, are entities, of which the principal activity consists in:

- owning or managing property;

- managing data-processing services;

- or any other similar activity which is ancillary to the principal activity of an insurance undertaking[10].

3.63. Ancillary entities that are subject to a significant influence should be consolidated through the equity method. Treatment in the group SCR should then be consistent with the treatment in the solo SCR.

3.64. Non-regulated, non-financial entities in the group are not subject to solo supervision as single entities.

CEIOPS' advice

3.65. The treatment of participations at group level should be based on the following criteria:
- the classification and method of the participation should be based on economic principles, not just on legal grounds. Control and influence should always be assessed at a group level to determine the significance of participations. This ensures that situations where several entities of a group have small participations in the same undertaking are not overlooked.
- in line with the principle above, the consolidation approach used for accounting purposes should be used for solvency purposes to the extent they are based on economic principles suitable for a solvency assessment.

3.66. Regulated financial entities with capital requirements should be included in the group calculation using the deduction aggregation method when it is not appropriate to include them through the consolidated method. This is to ensure there is no circumvention of the sectoral rules. In principle, when assessing the aggregated group SCR, capital charges on intra-group transactions should be eliminated. However, CEIOPS considers that further work may be done at level 3 in order to avoid arbitrage and any unintended consequences from a prudential point of view when applying the deduction and aggregation method.

[8] CEIOPS will publish a draft advice for consultation on the treatment of participations in November 2009.
[9] CEIOPS will publish a draft advice for consultation on the treatment of participations in November 2009.
[10] See also Art. 4.21 of directive 2006/48/EC for the definition of "ancillary services undertaking" .

3.67. The choice of the method should be made under the proportionality principle as per Article 29.

3.68. Nevertheless, the following principles may apply for (re)insurance participations in accordance with IAS/IFRS and national general accounting principles.

3.69. When the group's participation in a (re)insurer is regarded as a dominant influence this will imply a full integration of the participation in the accounts or a proportional integration (if there is jointly shared control of the participation). In the case of a fully integrated participation, minority interests would in turn contribute to cover part of the group SCR. The same treatment applies to an SPV over which dominant influence is exercised.

3.70. Where significant influence is exercised the contribution to the group SCR in respect of the participation should be calculated as the group's share in the participation multiplied by the solo SCR of this participation. This is consistent with the equity method consolidation where such participations are accounted for at equity value in the group's consolidated accounts. The contribution of these participations to the group SCR would be the sum of the above-mentioned calculations.

3.71. For the group solvency calculation, the treatment of the other financial regulated entities should be consistent with the Financial Conglomerate Directive (FCD).

3.72. Related credit institutions, investment firms and financial institutions shall, in accordance with the Financial Conglomerates Directive, be included in the group calculation using sectoral requirements and not allow for diversification.

3.73. In case of financial non-regulated undertakings a notional capital requirement shall be calculated.

3.74. Institutions for occupational retirement provision shall be included in the group calculation using sectoral requirements and not allow for diversification.

3.75. As insurance holding companies can be established in a different jurisdiction than the parent undertaking, cooperation between supervisors is of utmost importance.

3.76. Controlled insurance holding companies shall be consolidated, that is a full integration of the participations in the intermediate insurance holding company and in the insurance undertakings participated by the intermediate insurance holding company is required.

3.77. As a general principle, participations in entities outside the financial sector (both dominant and significant influence) should be consolidated through the equity method. Treatment in the group SCR should then be consistent with the treatment in the solo SCR.

3.78. Controlled ancillary entities should be consolidated through a full integration of the participation in the accounts.

3.79. Ancillary entities that are subject to a significant influence should be consolidated through the equity method. Treatment in the group SCR should then be consistent with the treatment in the solo SCR.

Non-availability of the necessary information

3.80. Article 229 states:

> *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.*

3.81. Information concerns may arise for EEA and third country related undertakings for example due to legal impediments to the transfer of information.

3.82. Information concerning a related undertaking available for the statutory accounting consolidation (e.g. technical provisions in local GAAP) may not necessarily be available for the regulatory consolidated accounts. On that basis, the group should demonstrate that the necessary information is available for assessing group solvency. If the necessary information is unavailable, article 229 shall apply.

CEIOPS' advice

3.83. Information concerning a related undertaking available for the statutory accounting consolidation (e.g. technical provisions in local GAAP) may not necessarily be available for the regulatory consolidated accounts. On that basis, the group shall demonstrate that the necessary information for calculating the group solvency is available. If supervisors are not satisfied of the adequacy of the information, article 229 shall apply and then the related undertaking should be deducted.

3.2. Third countries and Group solvency[11][12]

3.84. This section intends to provide CEIOPS initial views on the inclusion of third countries entity in the group calculations. In early 2010, CEIOPS will

[11] Third country is the term used in the Level 1 text to refer to non-EEA country.
[12] Issues specific to internal models will be addressed in others CEIOPS consultation papers.

publish a consultation paper on the general criteria for equivalence. For groups, this will include:

- the equivalence of third country solvency regimes for the purposes of Article 227;

- the equivalence of third country prudential regimes for the purposes of Article 260 (where the head of the group is outside the EEA).

3.85. Following that, CEIOPS will provide further advice on the equivalence of third country regimes.

3.86. Nonetheless, CEIOPS considers it appropriate to outline its initial views on third countries to allow more time for discussion of the issues with groups and third country supervisors. Therefore, this section reflects CEIOPS preliminary thoughts on what is a very important issue for group supervision under Solvency II.

Recognition of diversification with third country entities

3.87. The Level 1 text provides for the inclusion of third country entities in the group calculations and hence recognises diversification that may exist from those entities. However, there may be factors that restrict the recognition of that diversification, including insufficient information. However, CEIOPS recognises that these issues may also affect undertakings within the Community and are not unique to third countries. For example, third country undertakings are implicitly included in the assessment laid out in section 3.4. For these reasons, the equivalence of the third country regime is not the only issue to consider when assessing diversification.

Consequence of equivalence decisions for the group calculation methods

3.88. This chapter outlines CEIOPS views on the consequences of equivalence decisions for the group calculations. There are two cases to be considered:

1. the head office of the group is in EEA and it applies the deduction and aggregation method;
2. the head office of the group is outside the EEA.

3.89. There is no requirement to undertake an equivalence assessment where the group SCR is calculated using the accounting-consolidation method (default method). This is because the Solvency II rules apply with respect to a third country undertaking's inclusion in the consolidated data.

3.90. The following tables outline a series of options depending on whether an equivalence decision has been made by the group supervisor or the European Commission.

Table1: EEA group applying the deduction and aggregation method

Decision adopted by	Decision taken by	Option (2nd paragraph	Capital requirement

the Commission (art.225.3)	Group Supervisor on equivalence (art.227.2)	art. 227.1) implemented by MS	and eligible own fund of a participating undertaking in a third-country
Equivalence	No decision to take	YES	Local requirements
		NO	Solvency II requirements
Non-equivalence	No decision to take	Only NO	Solvency II requirements
No-decision adopted	Equivalence	YES	Local requirements
		NO	Solvency II requirements
	Non-equivalence	Only NO	Solvency II requirements

Table2: Group with head office outside the EEA

Decision adopted by the Commission (art.260.2)	Decision taken by Group Supervisor on equivalence (art.260.1)	Sub group calculations required at EEA level
Equivalence	No decision to take	No
Non-equivalence	No decision to take	Yes, if needed
No-decision adopted	Equivalence	No
	Non-equivalence	Yes, if needed

3.2.2.1 The head of the group is in the EEA and the third country regime is not equivalent

3.91. Accounting Consolidation (Default method): There is no requirement to assess equivalence. The group calculation will be done by the parent undertaking in the EU on consolidated accounts which includes the related third-country (re)insurance undertakings. The calculation is based on Solvency II rules as laid out in Article 230. As a result, diversification can be recognised on a worldwide level. In this context, it is necessary to consider the chapter on fungibility and transferability of own funds in this paper.

3.92. The group should be able to demonstrate the availability and quality of the required data and information. The value of the assets and liabilities of the related third-country insurance and reinsurance undertakings should be accurately included in the consolidated accounts to ensure an appropriate group SCR calculation. The assessment of the accuracy of data should be included as part of the supervisory review process.

3.93. Deduction and Aggregation (Alternative method): The group calculation will be done by the parent undertaking in the EU. The solo SCR and own funds of the related third-country undertakings will be calculated under the Solvency II rules and added to the aggregated group SCR and own funds. The technical outcome of the method is that there is no recognition of diversification in the group calculation as it simply reflects the sum of the solo capital requirements and capital resources. The group should be able to demonstrate the availability and quality of the required data and information. The value of the assets and liabilities of the related third-country (re)insurance undertakings should be accurately included to ensure an appropriate aggregated group SCR calculation. The assessment

of the accuracy of data should be included as part of the supervisory review process.

3.2.2.2 The head of the group is in the EEA and the third country regime is equivalent

3.94. Accounting Consolidation (Default method): See paragraphs 3.92 and 3.93.

3.95. Deduction and Aggregation (Alternative method): The group calculation will be done by the parent undertaking in the EU. Where the third-country regime is found equivalent, the SCR and own funds calculated in accordance with the local rules may be included in the aggregated group calculations. The technical outcome of the method is that there is no recognition of diversification in the group calculation as it simply reflects the sum of the solo capital requirements and capital resources.

3.96. The group should be able to demonstrate the availability and quality of the required data and information. The value of the assets and liabilities of the related third-country insurance and reinsurance undertakings should be accurately included to ensure an appropriate aggregated group SCR calculation. The assessment of the accuracy of data should be included as part of the SRP.

3.2.2.3 The head of the group is outside the EEA and the third country regime is not equivalent

3.97. The Solvency II rules on group supervision apply by analogy where the third country regime is found non-equivalent. The group calculation should be done at the level of the insurance holding company or third country (re)insurance undertaking based on the accounting consolidation method or the alternative method. The verification shall be carried out by the supervisory authority which would be the group supervisor if the criteria set out in Article 247 (2) were to apply.

3.98. Article 262(2) provides for the use of other methods to ensure the appropriate treatment of undertakings in the group. This provision provides supervisory authorities with the option to require the establishment of an insurance holding company which has its head office in the Community. The group supervision rules of Title III can be applied at the level of this insurance holding company which would establish an EEA subgroup.[13] This ensures that the parent undertaking at Community level and EEA subgroup are subject to Solvency II requirements.

3.99. Where this option is exercised, it is important that the group consults the supervisory authority which would be the group supervisor in determining the location of the EEA holding company. This is to ensure that the outcome does not have any unintended consequences or generate unnecessary regulatory costs.

[13] Article 213(2)(b).

3.2.2.4 The head of the group is outside the EEA and the third country regime is equivalent

3.100. Article 261 states that, in the case of equivalnt supervision referred to in Article 260, Member States shall rely on the equivalent group supervision exercised by the third-country supervisory authorities. Articles 247 to 258 on supervisory cooperation apply *mutatis mutandis*, which means that EEA supervisors would expect to play a role in the cooperation arrangements of the third country group supervisor. This highlights the importance of cooperation arrangements with third country supervisors to ensure the appropriate level of supervision of EEA entities.

3.101. CEIOPS notes that in the absence of a determinative decision on equivalence made by the European Commission, supervisory authorities may come to different equivalence decisions on the same third country regime. This raises the risk of inconsistency in the treatment of third country regimes and for the calculation of group solvency in the EEA. This highlights the importance of the European Commission to make binding decisions on equivalence to promote consistency and the harmonisation of Solvency II.

CEIOPS' advice

3.102. The Level 1 text provides for the inclusion of third country entities in the group calculations and hence recognises diversification that may exist from those entities. However, there may be factors that restrict the recognition of that diversification, including insufficient information on an undertaking and the lack of fungibility or transferability of own funds. However, CEIOPS recognises that these issues may also affect undertakings within the Community and are not unique to third countries.

3.103. CEIOPS considers that third country entities should be included in the assessment of fungibility and transferability of own funds laid out in this paper.

The group shall be able to demonstrate the availability and quality of the required data and information. This includes the accuracy of the information used to calculate the group SCR. The assessment of the accuracy of data shall be included as part of the supervisory review process.

3.104. CEIOPS considers it important that the European Commission makes determinative decisions on equivalence to promote consistency and the harmonisation of Solvency II.

3.3. Calculation method

3.105. The calculation of group solvency requires on one side to calculate the group SCR and on the other side to determine the amount of own funds within the group eligible to cover the group SCR.

3.106. The Level 1 text provides for some general principles concerning the group solvency calculation and especially Article 221 states that the calculation of group solvency shall take account of the proportional share held by the participating undertaking. Later on in this advice it is assumed that this general principle will always apply.

3.3.1. The accounting consolidation-based method

Explanatory text

3.107. The accounting consolidation-based method provides for the calculation of group solvency based on a set of consolidated accounts. The group solvency margin is the difference between own funds eligible to cover the SCR (see Section 3.4) and the group SCR calculated on the basis of consolidated data (the consolidated group SCR).

3.108. The group SCR calculated with the consolidated-accounting method is:

a. the SCR calculated on the (re)insurance part of the group composed by all (re)insurance undertakings for which diversification is recognised, named group SCR*;

b. the sum of solo capital requirements SCRj calculated on each other regulated undertaking j for which no diversification is recognised:

- (re)insurance undertakings on which significant influence is exercised,
- credit institutions, investment firms and financial institutions,
- any other regulated entities for which a specific capital requirement should be assessed,
- where supervisors decide not to recognise diversification with a (re)insurance undertaking.

3.109. When participation in another financial sector forms a group for which a specific capital requirement exists, the latter (instead of the sum of the requirements of each solo entity) should be used (see also QIS 4 - TS. XVI.B.19).

3.110. Article 221 provides for the treatment of proportional shares in related undertakings when calculating the consolidated group SCR. The proportional share is the percentages used for the establishment of the consolidated accounts. However, where a subsidiary is in deficit, the total solvency deficit of the subsidiary shall be taken into account unless the group supervisor is convinced that the parent undertaking's responsibility is strictly limited to that share of the capital, whereby the deficit will be taken into account on a proportional basis. In making such a decision, the group supervisor could consider the extent to which the parent

undertaking may be obliged to provide additional capital to the undertaking.

3.111. A key issue for supervisors in determining group solvency based on consolidated data is the treatment of third country undertakings. The issue from a supervisory perspective is the extent to which supervisors can assess the data to identify assets and liabilities originating from outside the EEA. Therefore, CEIOPS considers that groups should be able to identify the data relating to third country undertakings in the consolidated group SCR and own funds calculations. This should also apply to credit institutions, investment firms and financial institutions.

CEIOPS' advice

3.112. Groups shall be able to identify the data (e.g. the contribution of the own funds) relating to each regulated entities in the consolidated group SCR and own funds calculations. The data shall be assessed as part of the supervisory review process.

3.3.2. The deduction and aggregation method

Explanatory text

3.113. The deduction and aggregation method (alternative method) calculates the group solvency as the difference between the sum of the aggregated own funds in the group and the aggregated solvency capital requirements in the group. Diversification effects are already recognised in solo calculations, but the deduction and aggregation method does not allow for additional diversication effects at group level as the group SCR represents the sum of the solo SCRs.

3.114. Article 221 provides for the treatment of the proportional share in related undertakings when calculating the aggregated group SCR. The proportional share is the proportion of the subscribed capital that is held, directly or indirectly, by the parent undertaking. The approach described for the treatment of solvency deficits described under method 1 also applies for method 2. The same principles should be used for the assessment of indirect ownership referred to in Article 233(4).

3.115. When calculating the aggregated group SCR the capital charge on intra-group transactions should be eliminated in order to avoid charging two times the same risk. This will imply as already tested in QIS4:

- for internal reinsurance that the capital charge of the internally reinsured undertakings shall calculate its adjust its solo SCR by eliminating the counterparty default charge on the internal reinsurer (as long capital charge for the risks are considered in the underwriting risk in the solo SCR of the internal reinsurer);
- for participating undertakings to eliminate the capital charge on their participations (as long as risks stemming from those entities are taken into account via the solo SCR of those entities).

3.116. The SCR adjusted for those eliminations of double counting of intra-group transactions should never be lower than the MCR of the considered (re)insurance undertaking as the floor to group MCR only applies to the part of the group SCR calculated with the consolidated-accounting method.

3.117. CEIOPS will further elaborate Level 3 guidance on the necessary adjustments to eliminate double counting of intra-group transactions when calculating the adjusted solo SCR of (re)insurance undertakings for the purpose of assessing the group SCR with the deduction-aggregation method or a combination of the calculations methods foreseen in the level 1 text.

CEIOPS' advice

3.118. The deduction and aggregation method does not provide for the recognition of diversification at group level.

3.119. When calculating the aggregated group SCR the capital charge on intra-group transactions should be eliminated in order to avoid double charging for the same risk. Therefore for the deduction and aggregation method, the solo SCR should be understood as the solo SCR that has been adjusted to eliminate the effect of intra-group transactions. As this adjustment is made purely for the purposes of group solvency, the solo SCR remains unchanged.

3.120. The solo SCR that has been adjusted for the elimination of double counting of intra-group transactions should never be lower than the MCR of the (re)insurance undertaking as the floor of the group MCR only applies to the part of the group SCR calculated with the accounting consolidation method.

3.3.3. Choice of method

Explanatory text

3.121. Article 220 states that the calculation of group solvency shall be ***c***arried out according to the accounting consolidation-based method (Method 1). Therefore, unlike the IGD, the Level 1 text provides for a preferred method for the group calculation.

3.122. However, the text also states that the Member States shall allow their supervisory authorities, where they assume the role of the group supervisor, to decide in consultation with the supervisory authorities concerned and the group itself, to apply the deduction and aggregation method (Method 2) or a combination of both methods "*where the exclusive application of method 1 would not be appropriate".*

3.123. Therefore, supervisors, in consultation with the group itself, must consider the circumstances in which the group supervisor may wish to require a group to use method 2 or a combination of the two methods because the use of method 1 is inappropriate.

3.124. Any such decisions are important because it will impact on the extent to which diversification effects may be recognised at group level and the level of complexity in the group calculations. As noted in QIS4 by some groups and supervisors, in some circumstances the use of Method 2 may be appropriate and relatively fast and simple to carry out.

3.125. CEIOPS considers that the group supervisor, after consultation with the other supervisors concerned and the group itself, should assess, in particular:

- the quality and access to information on an undertaking;
- the impact of new entities falling within the scope of group supervision (i.e. restructures, mergers and acquisitions);
- the use of group internal models;
- the level of complexity of the group calculation that would arise when requiring a combination of methods and the impact on effective group supervision.

3.126. However if a significant part of the group is still able to be consolidated based on method 1 such a method should be used and the entities for which it is not appropriate should be added by means of deduction and aggregation method.

3.127. The decision of the group supervisor according to Article 218(2) shall be applied in a consistent manner over time.

3.128. CEIOPS considers that Level 3 guidance is necessary to provide further details on the circumstances where the group supervisor may require the use of Method 2 or a combination of Methods 1 and 2.

CEIOPS' advice

3.129. CEIOPS acknowledges that according to the Level 1 the accounting-consolidation method is the default method, for group solvency. However, the deduction and aggregation method can be useful for dealing with specific group structures.

3.130. When making a decision pursuant to Article 220(2), the group supervisor, after consultation with the other supervisors concerned and the group itself, shall assess, in particular:

- the quality and access to information on an undertaking;
- the impact of new entities falling within the scope of group supervision (i.e. restructures, mergers and acquisitions);
- entities that fall within the scope of a group internal model;
- the level of complexity of the group calculation that would arise when requiring a combination of methods and the impact on effective group supervision.

3.131. The decision of the group supervisor according to Article 218(2) shall be applied in a consistent manner over time.

3.132. However if a significant part of the group is still able to be consolidated based on method 1 such a method should be used and the entities for which it is not appropriate should be added by means of deduction and aggregation method.

3.4. Eligible elements of own funds

3.133. Article 222(1) titled "Elimination of double use of eligible own funds" states:

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.

For that purpose, when calculating the group solvency and where the methods described in Subsection 4 do not provide for it, the following amounts shall be excluded:

(a) the value of any asset of the participating insurance or reinsurance undertaking which represents the financing of own funds eligible for the Solvency Capital Requirement of one of its related insurance or reinsurance undertakings;

(b) the value of any asset of a related insurance or reinsurance undertaking of the participating insurance or reinsurance undertaking which represents the financing of own funds eligible for the Solvency Capital Requirement of that participating insurance or reinsurance undertaking;

(c) the value of any asset of a related insurance or reinsurance undertaking of the participating insurance or reinsurance undertaking which represents the financing of own funds eligible for the Solvency Capital Requirements of any other related insurance or reinsurance undertaking of that participating insurance or reinsurance undertaking.

3.134. Article 222(3) states:

Where the supervisory authorities consider that certain own funds eligible for the Solvency Capital Requirement of a related insurance or reinsurance undertaking other than those referred to in paragraph 2 cannot effectively be made available to cover the Solvency Capital Requirement 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 Solvency Capital Requirement of the related undertaking.

3.135. Article 223 titled "Elimination of the intra-group creation of capital" states:

1. When calculating group solvency, no account shall be taken of any own funds eligible for the solvency capital requirement arising out of reciprocal financing between the participating insurance or reinsurance undertaking and any of the following:

(a) a related undertaking;

(b) a participating undertaking;

(c) another related undertaking of any of its participating undertakings.

2. When calculating group solvency, no account shall be taken of any own funds eligible for the Solvency Capital Requirement of a related insurance or reinsurance undertaking of the participating insurance or reinsurance undertaking for which the group solvency is calculated when the own funds concerned arise out of reciprocal financing with any other related undertaking of that participating insurance or reinsurance undertaking.

3. Reciprocal financing shall be deemed to exist at least when an insurance or reinsurance undertaking, or any of its related undertakings, holds shares in, or makes loans to, another undertaking which, directly or indirectly, holds own funds eligible for the Solvency Capital Requirement of the first undertaking.

3.136. The group solvency assessment must be based on the overall position of the group in order to take into account the integrated nature of risk management and capital management within the group. In addition, the composition of the group should also be taken into consideration, for example, the inclusion of third countries entities and non insurance entities.

3.137. In order to assess the group solvency, it is necessary to determine the amount of group own funds which are eligible for covering the group SCR[14]; that assessment needs in particular to take consideration of the availability of the own funds of each entity within the scope of group solvency, but also of the tiers limits laid out in the directive.

3.138. For the aim of that paper, the available group own funds are the group own funds after adjustment for availability of excess solo own funds, and eligible own funds are obtained after having applied tiers limits to available group own funds.

3.139. In addition, solo own funds have to be treated in accordance with articles 222(1), especially to cancel impact generated by double use of eligible own funds; later on in this paper, solo own funds and solo SCR should be understood as solo adjusted own funds and solo adjuted SCR.

3.140. Solo excess own funds above their respective solo SCR in some (re)insurance undertakings can compensate for possible under coverage of SCR in other (re) insurance undertakings. However, these solo excess own

[14] This assessment has to be made for both calculation methods (default or deduction/aggregation) and except where mentioned, considerations in part 3.4 are valid for both methods.

funds may not be always available, due to local legal or prudential constraints on the own funds.

3.141. When diversification benefits arise at the level of a solo undertaking, simply understanding how the various individual risks diversify and aggregate is sufficient for one to be able to assess the risk to the solvency of the entity. However, when diversification benefits arise across multiple entities within the same group, consideration also needs to be given to the extent to which own funds can move between the different entities. If own funds cannot move between different undertakings, then although the group has adequate own funds after allowing for diversification, at the time of stress and also in on going concern the necessary own funds could not be delivered to a particular entity. Therefore, consideration of the extent to which own funds are truly mobile within a group is critically important to understand group solvency.

3.142. As stated in Article 222(3), if the supervisory authorities find that certain own funds eligible for the SCR of a related (re)insurance undertaking other than those referred to in Article 222(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 they are eligible for covering the SCR of the related undertaking.

CEIOPS' advice

3.143. Therefore, for the calculation of available group own funds it is necessary to:

- analyse the group own funds in order to identify the eligible group own funds;
- assess the eligible own funds within each entity that are not able to absorb losses in other entities within the group and, consequently, may be included in the calculation in so far as they are eligible for covering the SCR of the related undertaking.

3.144. Moreover, CEIOPS considers that the assessment of the availability of group own funds requires an analysis of other factors, including:

- the solvency position of the transferor after a possible transfer of own funds;
- the extent to which own funds can be transferred from an entity to another one without prejudicing the ability of the entity to meet policyholder claims or damaging its business;
- the regulatory regime itself, which can create barriers to the movement of own funds.

3.145. The available group own funds are the group own funds after adjustment for availability of excess solo own funds, and eligible own funds are

obtained after having applied tiers limits to available group own funds.

3.146. In addition, solo own funds have to be treated in accordance with articles 222(1) and 223[15], particularly to cancel the effect of any intra-group transactions and the internal creation of capital.

3.4.1 Fungibility and Transferability

3.147. This section provides advice on the treatment of certain elements of own funds. It takes into account the potential restrictions on the fungibility and transferability of own funds that may exist as a consequence of the underlying nature of own funds elements and of the legal and regulatory environment in which the undertakings operate.

3.148. These two criteria are linked but distinct from each other. Indeed, own funds may be:

- fungible at group level and transferable; here the own funds are considered available for the group;
- not fungible at group level but transferable; here the own funds are not considered available for the group;
- fungible at group level but non-transferable; here the own funds not are considered available for the group.

CEIOPS' advice

3.149. In order to assess the available group own funds, CEIOPS considers the term '*effectively be made available*' in Article 222(3) linked to the combination of two concepts: fungibility at group level and transferability.

3.150. CEIOPS considers that for the purposes of this advice:

- **Fungibility** at group level means that an element of own funds can fully absorb any kind of losses within the group, regardless of the undertaking within which those own funds are held or where the commitments arise (in compliance with the local prudential and legal rules). Fungible own funds in this sense are thus not dedicated to a certain purpose. Fungibility of own funds at solo level doesn't automatically imply fungibility at group level.
- **Transferability** refers to the ability to transfer own funds from one undertaking to another within the group. Transferability leads to increase/decrease of own funds in a solo entity without increasing/decreasing the group own funds, except the likely cost of

[15] Adjustment for double-use of own funds and reciprocal financing. This adjustment has to be made for both calculation method (default or deduction/aggregation)

the transfer. The time and the costs of the transfer have indeed to be taken into account.

- These two steps are linked but distinct from each other. Indeed, own funds may be transferable but not fungible in the contest of Solvency II and *viceversa*.

3.151. In principle, eligible own funds at group level are assessed following a five steps approach for the default method (illustrated in Annex 2):

1. The balance sheets[16] of all entities belonging to the group are consolidated according to the accounting consolidation rules (IGT and internal creation of capital are eliminated).

2. The regulatory consolidated balance sheet results from[17]:

   i. adjustment of the scope of supervision (if different from the scope of accounting consolidation);

   ii. treatment of related undertakings for which the necessary information is unavailable (Article 229);

   iii. treatment of related credit institutions, investment firms and financial institutions (Article 228) and other regulated entities.

   At this stage, the group SCR is calculated on the regulatory consolidated balance sheet.

3. Assessment of the contribution of each undertaking to available group own funds.

   The contribution to available group own funds of an undertaking's unavailable own funds is limited by:

   - its contribution to the group SCR* of each (re)insurance undertaking included in a)[18] (see par. 3.148 for the calculation of that contribution);

   - its SCRj for each undertaking included in b)[19].

   For each entity included in the regulatory consolidated balance sheet, the excess unavailable own funds is the difference, if positive, between its unavailable own funds and the contribution mentioned above.

4. The available group own funds (AGOF) to cover the group SCR are calculated by deducting from the regulatory group own funds the sum of unavailable solo excess own funds (determined for each entity included in the regulatory consolidated balance).

[16] Based on the Solvency II balance sheet.
[17] In practice, adjustments are done to the statutory consolidated accounts as mentioned to CEIOPS by stakeholders.
[18] See section 3.3.1.
[19] See section 3.3.1.

5. In order to be eligible to cover the group SCR the AGOF must comply at group level with the tiers limits laid out in the directive.

3.152. For the deduction and aggregation method, only eligible elements at solo level can be considered as eligible at group level in accordance with Article 231. The adjustment for diversification effects is not needed, but the solo own funds which cannot be considered available to cover the group SCR can only be included in so far as they are eligible for covering the SCR of the solo undertaking.

3.4.2 Limitation to the inclusion of solo excess non available own funds in the available group own funds

3.153. When using the accounting consolidation-based method, as stated in step 4 of the former assessment, the extent to which the group excess own funds can be increased by group diversification effects –measured as the difference between the group SCR and the sum of solo SCR[20]- must be reduced by the amount of unavailable solo excess own funds (i.e. solo own funds that cannot be used to meet capital requirements in other parts of the group). In order to assess that availability, it has been chosen in step 3 to undertake a theoretical allocation of the diversification benefits to determine the contribution of each undertaking to the group SCR.

3.154. The contribution to Group SCR* from entity k $(Contr_j)$ is calculated as follows:

Option A (default method):

$$Contr_j = SCR_j \times \frac{Group\ SCR}{\sum_i SCR_i}$$

where:

- the index (i) covers all entities of the group included in the calculation of the $Group\ SCR$
- SCR_i, SCR_k refer to the solo SCR adjusted for intra-group transactions
- the ratio is a proportional adjustment due to diversification effects.

3.155. As mentioned in QIS3 and QIS4, CEIOPS is aware that the theoretical assessment of contribution to the group SCR set out in option A could produce an inequitable allocation where the effects of standard formula group diversification are significantly different for different parts of a group. The effect of an inequitable theoretical assessment of contribution to the group SCR may affect the extent to which eligible own funds in subsidiaries

[20] Solo SCR are solo SCR adjusted for IGT.

are included in group eligible own funds and the inclusion within eligible group own funds of a minority interest in the SCR of a subsidiary. CEIOPS considers that further work is needed to adequately cope with the reality if that allocation appears to be inappropriate in practice.

Option B (only for group internal model):

3.156. The group may use a group specific assessment of the contributions of the related (re)insurance undertakings where a group internal model has been used for the assessment of the Group SCR*. In any case, the sum of all individual contributions shall be equal to the group SCR.

3.157. The allocated diversification effects (which do not affect the solo SCR) should then be assessed for any restrictions on the availability of solo own funds. The sum of the excess of own funds identified as unavailable should then be deducted from group own funds.

3.158. CEIOPS is aware that eligible own funds within the group may increase as a result of an increased availability of own funds within the group due to the internal reinsurance arrangement (cf. section on internal reinsurance).

CEIOPS' advice

3.159. When using the accounting consolidation-based method, the extent to which the group excess, calculated as the difference between eligible group own funds and group SCR, can be increased by group diversification effects must be reduced by the amount of unavailable solo excess own funds (i.e. solo own funds that cannot be used to meet solvency requirements in other parts of the group).

3.160. In order to assess the amount of solo own funds that are available at the group level, it is necessary to undertake a theoretical allocation of the diversification benefits.

3.161. This shall by default be done by a proportional allocation when the standard formula is applied.

3.162. CEIOPS considers that further work is needed to adequately cope with the reality if that allocation appears to be inappropriate in practice. The group may use a group specific assessment of the contributions of the related undertakings where a group internal model has been used for the assessment of the group SCR. In such a case, the sum of all individual contributions shall be equal to the group SCR as when using the proportional allocation when the standard formula is applied.

3.163. The allocated diversification effects (which do not affect the solo SCR) should then be assessed for any restrictions on the availability of solo own funds. The sum of the excess of own funds identified as unavailable should then be deducted from group own funds.

3.4.3 Fungibility of own funds at group level

3.164. According to the Level 1 text, not fungible own funds of a related undertaking cannot be fully included for group solvency purposes, but may be included in the calculation only in so far as they are eligible for covering the SCR of this related undertaking.

3.165. This means that they can be considered available to cover the group SCR of the participating undertaking up to the contribution of the SCR of the related undertaking to the group SCR (and after consideration of transferability constraints).

3.166. As a result, for the calculation of eligible group own funds, it is necessary on a case-by-case basis to split the solo own funds into fungible at group level and non fungible own funds at group level.

3.167. Article 222 (2) states that the following may only be included in the calculation of group own funds for covering the group SCR so far as they are eligible for covering the solo SCR of the related undertaking concerned:

a) surplus funds falling under Article 90(2) arising in a related life insurance or reinsurance undertaking of the participating insurance or reinsurance undertaking for which the group solvency is calculated;
b) any subscribed but not paid-up capital of a related insurance or reinsurance undertaking of the participating insurance or reinsurance undertaking for which the group solvency is calculated.

3.168. Article 222(3) states that:

if the supervisory authorities consider that certain own funds eligible for the Solvency Capital Requirement of a related insurance or reinsurance undertaking other than those referred to in paragraph 2 cannot effectively be made available to cover the Solvency Capital Requirement 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 Solvency Capital Requirement of the related undertaking.

3.169. CEIOPS considers that further work may be useful in order to identify fungibility limits at level 3 in order to ensure a consistent implementation of Solvency II.

CEIOPS' advice

3.170. CEIOPS considers that, *inter alia*, the following items may only be included in the assessment of group solvency in so far as they are eligible for covering the solo SCR of the related undertaking concerned:

- own funds at solo level with restricted availability
- some types of with-profit business
- own funds in ring-fenced funds
- hybrid capital and subordinated liabilities
- minority interests
- ancillary own funds
- deferred tax assets

3.171.. As regards the fungibility of deferred taxes, CEIOPS may further consider in Level 3 the case on undertakings belonging to the same fiscal group and located in the same country. CEIOPS considers that if the supervisory authority finds that some of the eligible own funds of a related undertaking, other than those indicated in the previous paragraph, are not effectively available for meeting commitments of the parent undertaking, these own funds may also be taken into account as eligible own funds for covering the group SCR only in so far as they are eligible for covering the SCR and up to the contribution of the related undertaking to the group SCR.

3.172. The assessment of the fungibility of a given solo own funds will notably depend on the principle of valuation of that given own fund in the balance sheet (cf CEIOPS advice on the valuation of assets and other liabilities[21]); e.g. Off-balance-sheet commitments are all considered non fungible at group level.

Some types of with-profit business

3.173. In QIS4, some supervisors expressed concerns over the inclusion of some type of with-profit business in the calculation of diversification effects at group level. In their opinion for these types of with-profit business (type A with-profit business), they should not be attributable to the group own funds. Other supervisors highlighted that the treatment of with-profit business is not homogeneous across the EEA and that such differences should be taken into account.

3.174. As a result, the straight application of the standard formula to the consolidated accounts might be quite complicated and difficult to interpret. In its paper "*Background paper for cross-border insurance groups on the treatment of with-profit business in QIS4*"[22], CEIOPS provided - for the purposes of the QIS4 - a guide on the treatment of such products with

[21] CEIOPS-DOC-31/09 (October 2009), see http://www.ceiops.eu//content/view/17/21/.
[22] CEIOPS-SEC. 35/98, 24 April 2008, available on CEIOPS website.

some national guidance in order to take into account the different features of with-profit business across the EEA.

3.175. Some type of with-profit businesses (type A with-profit business) contain items of eligible own funds and/or profit sharing mechanisms within the technical provisions, which can only be used to cover the liabilities for a limited set of policyholders. In this case, the parent undertaking may not be able to extract own funds, including own funds in excess of the SCR attributable to the relevant business, and hence the own funds are considered non-fungible.

3.176. The own funds related to with-profit business where the value of the policyholders' benefit is not based on the value of the assets assigned to the segregated fund (i.e. it is not "unitised"), but on the return of the assigned assets, are calculated in accordance with specific rules. In these types of with-profit business (type B with-profit) , the own funds can be considered available to absorb losses of other entities of the group only when appropriate mechanisms are triggered to avoid damaging the policyholders' contractual right to receive the return expected in normal circumstances.

3.177. The own funds (generated by Type A with-profit business) may be included in the calculation of the group own funds only in so far they are eligible for covering the SCR of the related undertaking and up to the contribution of the related undertaking to the group SCR.

CEIOPS' advice

3.178. When own funds related to some types of with-profit business are only available to cover capital requirements in one undertaking of the group they should be included in the calculation of the group own funds only in so far they are eligible for covering the SCR of the related undertaking to the group SCR and up to the contribution of the related undertaking to the group SCR.

Ancillary Own Funds

3.179. Under Article 222(5), any ancillary own funds of a related (re)insurance undertaking for which the group solvency is calculated may only be included in the calculation in so far as the ancillary own funds have been duly authorised by the supervisory authority responsible for the supervision of that related undertaking.

3.180. Without prejudice of Article 222(2), CEIOPS considers that the group supervisor in cooperation with the College of supervisors should assess the availability of ancillary own funds in a related (re)insurance undertaking , and especially the delay and the cost of availability. Those ancillary own funds may be included in the calculation only in so far they are eligible for covering the SCR of the related undertaking and up to the contribution of the related undertaking to the group SCR.

CEIOPS' advice

3.181. CEIOPS considers that the group supervisor in cooperation with the College of supervisors should assess the availability of ancillary own funds in a related (re)insurance undertaking, and especially the delay and the cost of availability. Those ancillary own funds may be included in the calculation of the group own funds only in so far they are eligible for covering the SCR of the related undertaking and up to the contribution of the related undertaking to the group SCR.

Hybrid capital and subordinated liabilities

3.182. As noted in QIS4, there is a broad spectrum of capital instruments that are potentially eligible in own funds at solo level and group level. These include equity instruments with debt-like features and debt instruments with equity-like features.

3.183. There is some divergence in the approach to subordinated liabilities. Some Member States consider subordinated liabilities to be hybrid capital instrument while others consider subordinated liabilities to be distinct from hybrid capital instruments.[23]

3.184. QIS4 found that the proportion of hybrid capital instruments and subordinated liabilities is on average 13% at group level compared to an average of 2% at solo level.

3.185. This higher percentage at group level was expected as often undertakings raise capital at the parent company or holding level and down-stream and/or lend it to subsidiaries in the form of higher quality capital.

3.186. CEIOPS considers that hybrid capital and subordinated debts cannot, in principle, be considered as available to cover the SCR of the participating undertaking if it is not issued or guaranteed by the ultimate parent undertaking of the group. This depends on the rights of the subscribers on the revenues of these instruments. In particular, subordinated liabilities issued by group undertakings are normally only available to support the business of the issuing undertaking because of its legal liability to subscribers to those debts.

3.187. Consequently, CEIOPS considers that hybrid capital instruments and subordinated liabilities issued by undertakings other than the ultimate parent undertaking should be admitted to contribute to the coverage of the group SCR only in so far they are admitted for covering the SCR of the related undertaking.

[23] As already stated in QIS4 call for advice the definition of "subordination" is similar to the definition used for accounting purpose, i.e. capital items should not only be subordinated to policyholders' interests but to all liabilities which are not explicitly subordinated.

3.188. The same instruments issued by an undertaking operating in another financial sector can contribute to the coverage of the group SCR only in so far they are eligible to meet capital adequacy requirements as established in applicable sectoral legislation, and only within the limits provided therein.

3.189. Under specific conditions and upon a reasoned request of the participating undertaking required to calculate the group SCR, the group supervisor may assess if subordinated liabilities may contribute to the group SCR for a total in excess of their contribution to the solo SCR.

3.190. In order to make this assessment, the cooperation and exchange of information among the supervisory authorities in the colleges of supervisors is essential.

CEIOPS' advice

3.191. CEIOPS considers that hybrid capital and subordinated debts cannot, in principle, be considered as available to cover the SCR of the participating undertaking if it is not issued or guaranteed by the ultimate parent undertaking of the group. This depends on the rights of the subscribers on the revenues of these instruments. In particular, subordinated liabilities issued by group undertakings are normally only available to support the business of the issuing undertaking because of its legal liability to subscribers to those debts.

3.192. CEIOPS considers that hybrid capital instruments and subordinated liabilities issued by undertakings other than the ultimate parent undertaking shall be admitted to contribute to the coverage of the group SCR only in so far they are admitted for covering the SCR of the related undertaking.

3.193. The same instruments issued by an undertaking operating in another financial sector can contribute to the coverage of the group SCR only in so far they are eligible to meet capital adequacy requirements as established in applicable sectoral legislation, and only within the limits provided therein.

3.194. Under specific conditions and upon a reasoned request of the participating undertaking required to calculate the group SCR, the group supervisor may assess if subordinated liabilities may contribute to the group SCR for a total in excess of their contribution to the solo SCR.

Minority interests

3.195. Minority interests and other shareholders of subsidiaries may affect the ability to transfer own funds out of a subsidiary.

3.196. Minority interest represents shares owned by third parties (or equity interest of outside shareholders) in a consolidated subsidiary. It represents the portion of the profit or loss and net assets of a subsidiary attributable

to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.[24]

3.197. Minority interest shares in any excess of own funds (above the solo SCR) of the consolidated entity are not available for use elsewhere in a group. Therefore a minority interest's share in any excess own funds should only be included in group own funds up to the minority interest's proportional share in the SCR of the insurance entity belonging to the group.

3.198. As a result, any excess own funds over capital requirements relating to a minority interest is not available at group level.

CEIOPS' advice

3.199. A minority interest's share in any excess own funds should only be included in group own funds up to the minority interest's proportional share in the SCR of the (re)insurance entity belonging to the group.

3.200. Any excess own funds over capital requirements relating to a minority interest is not available at group level.

Own funds in undertakings located in non-EEA countries

3.201. All (re)insurance undertakings of the group are captured in the group SCR calculations, including any non-EEA (re)insurance undertakings.

3.202. Eligible own funds in non-EEA countries are available to meet the SCR of the undertaking in which they are held but there may be situations where the own funds in excess of the SCR are not available for use elsewhere in the group.

3.203. In such cases eligible own funds in non-EEA are available to meet the SCR of the participating undertaking only in so far they are admitted for covering the SCR of the non-EEA undertaking and any excess own funds is not available at group level.

3.204. In particular, these situations may arise when there are restrictions to the fungibility and transferability of own funds. The equivalence of the third country regime may also impact on the availability of excess own funds in the undertaking.

3.205. Where such restrictions arise, CEIOPS considers it appropriate that any excess own funds over capital requirements relating to the third country (re) insurance undertaking are considered unavailable at group level.

[24] As stated in Article 219 of the Level 1 text, the calculation of the group own funds shall take account of the proportional share held by the participating undertaking in its related undertakings. Where the Accounting consolidation based method is used, the proportional share shall comprise the percentage used for the establishment of the consolidated accounts. This means that in the case of fully consolidated subsidiaries, the proportional share in accounting is 100%, irrespective of the actual participation.

3.206. In order to ensure a consistent implementation of Solvency II, CEIOPS considers that further work may be useful in order to identify a list of fungibility constraints on own funds in (re)insurance undertakings located in non-EEA countries.

CEIOPS' advice

3.207. Where there are restrictions on the fungibility or transferability of the excess own funds over the capital requirement in non-EEA (re)insurance undertakings, the own funds (in excess of the contribution of that undertaking to the group SCR) should not be included in the calculation of group own funds.

3.208. CEIOPS considers that if the supervisory authorities finds that some of the own funds of a related (re)insurance undertaking located in non-EEA countries are not effectively available for meeting commitments of the parent undertaking, these own funds should be taken into account as own funds for covering the group SCR only in so far as they are eligible for covering the SCR of that related undertaking and up to the contribution of the related undertaking to the group SCR.

3.4.4 Transferability of own funds

3.209. As a general principle, CEIOPS defines transferability as the ability to transfer own funds from one entity to another undertaking within the group. For the elements of own funds that are considered fungible, supervisory authorities have to assess in a second step whether the assets covering those elements can effectively be transferred.

3.210. Undertakings may transfer their own funds provided that the regulatory and statutory conditions are met. Basic own funds (BOF) cannot be transferred from an undertaking if the transfer would cause the undertaking to (cumulative conditions):

- no longer cover its SCR,
- no longer respect the own funds tier limits (especially no longer have enough BOF to cover the MCR).

3.211. BOF which are not required to be held in the subsidiary (above the regulatory requirements) are potentially transferable. However, they may not be transferable due to current or foreseen material, practical or legal restrictions to the prompt transfer of own funds or repayment of liabilities, particularly in crisis situations.

3.212. The restrictions on transferability should be assessed under the following considerations:

- the likely costs that will be deducted from the transferable own funds at the point of the transfer (e.g. tax obligations);

- the likely restrictions on the transfer of own funds at the point of the transfer (e.g. company law restrictions);
- the timing needed to transfer own funds[25];
- the lack of transferable assets to recover the financial position of another entity in difficulty;
- in more extreme cases, the ability of a parent company to extract own funds from an entity at all[26].

3.213. Transferability constraints may significantly decrease the amount of available own funds (or cancel the interest of the operation) that was supposed available to cover the SCR of the participating undertaking.

3.214. The assessment of transferability across the legal entities of the group, is essential in order to evaluate the available group own funds. A sound understanding of the transferability of own funds should also improve the management of crisis situations.

3.215. When assessing the group eligible own funds, the supervisors concerned will need to consider the extent to which own funds may be considered transferable between entities within the group without jeopardising the financial and solvency position of the transferor.[27]

3.216. Moreover, a conflict of interest can arise between the use of assets to provide financial support to the policyholders of an entity which is in financial difficulty and the possible threat this may cause to the policyholders of the entity providing the support.

3.217. If the supervisory authority ascertains that the transfer produces or runs the risk of producing negative effects on the undertaking's solvency or can undermine the interests of the policyholders, it shall require the undertaking to take the measures necessary to eliminate such negative or detrimental consequences.

Transferability of own funds in crisis situations

3.218. The impediments to the transferability of own funds are particularly relevant in crisis situations where the ability to act rapidly is critical. While the mechanisms for transferring own funds may work well under normal conditions, as soon as one or more undertakings in the group are in financial difficulty the transferability of that own fund may become difficult (e.g. due to legal restrictions, etc).

3.219. The group must assess the transferability of own funds in stress scenarios, including the timing and the costs with which the own funds can be allocated in those scenarios. CEIOPS consider that these stress tests could be further developed under Pillar II and Pillar III requirements under Level 3 guidance.

[25] CEIOPS advice to the EC n. 25.
[26] The option to realise the capital in a subsidiary by selling it will of course always remain open to a parent company. However, this option is not considered to provide transferable funds in the Solvency II regime, as the individual companies can not always be sold on timely basis. Hence, the locked value can not be released when it is needed.
[27] The concept of testing whether own funds are transferable between separate legal entities is also contained in the Banking Consolidation Directive (Art. 70 of the Banking Consolidation Directive (2006/48/EC).

3.220. When part of the group is stressed by adverse conditions, the liquidity of that part may come under pressure and hence the transfer of own funds that may have been promptly transferable under normal conditions, may require more time or additional cost. For example, it may take an undertaking time to sell some fixed assets, like land or buildings, before it can realize their value and this may make the transfer of own funds far less straightforward that would normally be the case.

3.221. This implies the following requirements on a group:

- scenario analysis on the impact of stress events on the transferability of own funds in the group. The analysis of stress scenarios should consider the impacts on all affected legal entities;
- a strategy on how the group would manage financial stress in one or several legal entities;
- contingency plans in place on how to raise and allocate capital in the event of losses that threaten the position of the group.

3.222. The supervisors concerned should assess the management of own funds under transferability constraints at group and solo level. This should include an assessment of the own funds under transferability constraints position of the group on going concern and under stressed conditions.

CEIOPS' advice

3.223. The assessment of the transferability of own funds is not a simple nor a static consideration. It is likely to change depending on the capital management of the group, different risk scenarios and on market situations.

3.224. If the supervisory authority ascertains that the transfer of own funds produces or runs the risk of producing negative effects on the undertaking's solvency or can undermine the interests of the policyholders, it shall require the undertaking to take the measures necessary to eliminate such negative or detrimental consequences.

3.225. Impediments to the transferability of own funds are particularly relevant in crisis situations where the ability to act rapidly is critical. While the mechanisms for the transferability of own funds may work well under normal conditions, as soon as one or more undertakings in the group are in financial difficulty the transferability of that own fund may become difficult.

3.226. The supervisors concerned should assess the management of own funds under transferability constraints at group and solo level. This should include an assessment of the own funds under transferability constraints on going concern and under stressed conditions.

3.227. CEIOPS considers that these stress tests could be further developed under Pillar II and Pillar III requirements in Level 3 guidance.

3.5. Calculations

3.5.1. General considerations

3.228. The group SCR is calibrated on the same basis as the SCR of a solo insurer – it aims to limit the probability of ruin to 0.5% for all the parts of the group. The group capital requirement equals the amount of external economic capital needed in a group to meet all the quantifiable risks, less the net impact of risk mitigation techniques, deriving from the business conducted by the entities that form the group.

3.229. This CEIOPS advice builds on the Level 1 text and should only elaborate on those parts of the Level 1 text that need further explanation. This should not be understood as CEIOPS having more interest in group specific risks that in the consolidated group Solvency Capital Requirement calculation that is already addressed in the Level 1 text.

3.5.2. Group specific risks

3.230. In order to reflect the total risks that the group may face, the group SCR should reflect the risks that arise at the level of the group and that are specific to the group. The Level 1 text is clear on this and states in Article 101(3) that the SCR should reflect all quantifiable risks to which an insurance or reinsurance undertaking is exposed to.

3.231. Also the Level 1 text requires that when determining whether the consolidated group Solvency Capital Requirement appropriately reflects the risk profile of the group, particular attention should be paid to any specific risks existing at the group level (group specific risks) that would not be sufficiently covered by the standard formula or the internal model used, because they are difficult to quantify.

3.232. The lessons learnt from the financial crisis illustrate the importance of group-specific risks, such as reputational risk, contagion risk, impact of intra-group transactions[28], operational risk. QIS4 also reported that entities within groups may face significant reputational risks and other group-specific risks.

Assessment Methodology

3.233. CEIOPS considers that group-specific risks should be addressed using the following approach:

- First, the group shall be required to calculate the group SCR either with the standard formula or an internal model.

- Second, supervisors shall acquire information on group-specific risks through, among other means, the group supervisory review process

[28] Cf CEIOPS advice CEIOPS-DOC-53/09.

(including the ORSA), stress tests, scenario analysis or other quantitative or qualitative measures.

- Third, if the group uses the standard formula and under the second step it has become clear that there is a significant deviation from the assumptions underlying the standard formula calculation (e.g. due to complex structures, etc.), the group supervisor shall adopt the necessary measures to correct this situation. For this purpose the group supervisor may require:

  a. the use of an internal model pursuant to Article 119; or

  b. the use of group specific parameters for underwriting modules (see CEIOPS advice on capital add-on[29]) where the deviation arises from the application of those modules.

- Alternatively, if the group uses an internal model, then the requirements of Articles 110 to 124 shall apply meaning that any deficiency due to group specific risks will have to be adressed in the same way as for any other risks.

- Finally, if the group is unable to fulfil the requirements above within an appropriate timeframe, the group supervisor, in consultation with the supervisors concerned, may decide as a last resort measure to impose a group capital add-on.

3.234. In the process mentioned above, supervisors will ensure that risks are not counted twice and that no risk is omitted.

3.235. The following sections describe some of the different types of risks that arise at the level of the group and possible assessments. This list should not be considered as exhaustive.

3.5.2.1 *Reputational Risk*

3.236. Reputational risk is defined as the risk of potential loss to an undertaking through deterioration of its reputation or standing due to a negative perception of the undertaking's image among customers, counterparties, shareholders and/or supervisory authorities. To that extent it may be regarded as less of a separate risk, than one consequent on the overall conduct of an undertaking.

3.237. The administrative or management body of the undertaking should be aware of potential reputational risks it is exposed to and the correlation with all other material risks.

3.238. The undertaking should pay great attention to understanding and recognising key values affecting the reputation, considering expectations of the stakeholders and sensitivity of the marketplace.

[29] [29] CEIOPS-DOC-49/09 (October 2009), see http://www.ceiops.eu//content/view/17/21/

3.239. As set out in Article 101, operational risk excludes risks arising from strategic decisions and reputation risk. Reputational risk is therefore a separate risk type.

3.240. Reputational risk can manifest itself in reduced customer retention and satisfaction, in new customer acquisitions becoming difficult and in declining turnover rates and higher refinancing costs. In addition, there are negative internal effects such as lower employee satisfaction, higher labour turnover, less identification with the company and less job appeal to potential employees.

3.241. Additionally, reputation risk should be reflected in the group's Own Risk and Solvency Assessment. It is essential that reputational risk is included in the business strategy and linked with the other risk types. This includes defining functions and responsibilities, the available instruments and the risk tolerance.

3.5.2.2 *Contagion Risk*

3.242. Following the definition from IAIS,[30] contagion risk mainly deals with possible adverse impacts on one entity of the group due to intra-group relationships. Contagion risk can be understood as a spill-over effect of risks that have manifested in other parts of the group. For instance, a reputational risk affecting one undertaking may impact another undertaking within the same group, solely based on the relationship that exists between the undertakings. Contagion risk can therefore stem from various sources, making it difficult to come to a standardised approach to dealing with contagion risk.

3.243. Additionally, contagion risk should be reflected in the group's Own Risk and Solvency Assessment.

3.244. Groups should deal with contagion risk within their Own Risk and Solvency Assessment. Because of the difficulties associated with measuring contagion risk in a standardised way, CEIOPS does not foresee the possibility to cover contagion risk explicitly in a quantitative way on top of all the other risks in the standard model, though it may be possible for groups to adequately capture contagion risk within an internal model.

3.245. Insurers that operate as part of a corporate group or a financial conglomerate usually have various contracts which bind them to each other in good times but also in times of need. Therefore such insurers are more exposed to contagion than others. Contagion risk can arise from the reputational impact of a misbehaving group member especially if they are using the same branding. Moreover problems associated with one part of a group can be transferred to other parts by market reluctance to deal with a group member of a tainted group. Another type of contagion relates to intra-group exposures. This risk varies with the size and the nature of the exposures involved.

[30] Contagion risk is the risk that an individual entity will be adversely affected by the actions of another entity within the group due to the relationships, direct or indirect, that exist between them.

3.246. A specific problem for financial conglomerates is that the illiquidity from the banking sector might spillover to the insurance member caused by the exchange of liquidity for bonds or similar illiquid assets.

3.247. Groups are highly exposed to contagion risks but it is not restricted to them. Many customers do not distinguish between insurance companies. Hence, if a few companies within the same brand fail the expectations of their customers, the whole brand could suffer from it.

3.248. In non-life insurance a catastrophe could lead to the financial instability of some insurers which, because of the interconnectedness of the branch, could cause decreasing share prices of insurance companies that are financially sound. This may decrease the reputation and the trust of customers in the whole branch. If some insurance companies misbehave in the adjustment of claims and the media broadcasts this, the reputation of the whole branch could also suffer.

3.5.2.3 *Operational Risk*

3.249. At solo level, the capital charge for operational risk is added to the Basic Solvency Capital Requirement (BSCR) and therefore does not provide any diversification benefit. At group level the operational risk capital requirements should be calculated in the same manner as at solo level.

3.250. Under QIS 4 large groups commented that summing the solo operational risk capital charges does not reflect the operational risk at group level in the case where certain services are shared by the legal entities or provided at the group level. The effectiveness of managing risks through dedicated centralised resources will not be reflected in the standard formula, therefore, any diversification effects are lost.

3.251. Where a group might standardise the use of certain services, which may improve the degree of control and lessen the impact of operational risk, there is also a greater complexity at group level. Further, it would be expected that the operational risk is equal for a group and for an essentially similar solo undertaking. The current calculation takes this into account.

3.252. Additionally, operational risk should be reflected in the group's Own Risk and Solvency Assessment.

3.5.2.4 Strategic risk

3.253. Strategic risk is defined as the risk of the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.

3.254. Strategic risk is a function of the incompatibility between two or more of the following components: the undertaking’s strategic goals, the business strategies developed and the resources deployed to achieve these goals, and the quality of implementation and the economic situation of the markets the undertaking operates in.

3.255. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The undertaking's internal characteristics should be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

3.256. The overall strategy of the undertaking should incorporate its risk management practices. In this sense, the undertaking should have a process for setting strategic-high-level objectives and translating these into detailed shorter-term business and operation plans.

3.257. It is the responsibility of the group to ensure that strategic risk is adequately managed not only at solo level, but also at group level.

3.5.2.5 Intra group transactions and concentration risks

3.258. Concentration risk comes both from the fact that some entities of the group are not consolidated and from the interdependency between the different entities of the group that exposes the parent entity to a holistic failure of the group.

3.259. Although not reflected in the consolidated balance sheet, intra-group transactions risk should be considered and are captured by Article 245. Intra group transactions and risk concentration are further discussed in CEIOPS-DOC-53/09.

3.260. Finally, the FCD review is assessing the treatment of participations with respect to the reporting of risk concentration (RC) and intra-group transactions (IGT). The JCFC has noted some of the difficulties that financial conglomerates can have in accessing information on participations and how to treat unregulated entities in the group reporting requirements. CEIOPS notes that the reporting of RC and IGT in the Level 1 text is consistent with the FCD, and that the outcomes of the FCD review may also be relevant to Solvency II.

3.5.2.6 Internal reinsurance

3.261. A reinsurance arrangement entered into within a group should not result in a decrease in the group SCR in the absence of financing external to the group when using the default method. Group regulatory capital requirements are only permitted to be reduced therefore if the risk is being transferred outside of the group.

3.262. Exceptions to this principle may be a party external to the group is involved in the reinsurance arrangement for example by providing finance as part of the arrangement.

3.263. The analysis should include the impact of the default of the main entity of the group responsible of external reinsurance, taking into account not only the impact in the moment of default but also taking into account the necessity of a new hedging.

3.264. CEIOPS may develop further guidance at level 3 on that area.

CEIOPS' advice

3.265. Operational risk including legal risk is covered in a quantitative way in the SCR calculation. It is not considered a group-specific risk.

3.266. At group level the operational risk capital requirements will be calculated in the same manner as at solo level.

3.267. In order to reflect the total risks that the group may face, the group SCR shall reflect the risks that arise at the level of the group and that are specific to the group.

3.268. CEIOPS considers that group-specific risks shall be addressed using the following approach:

- First, the group shall be required to calculate the group SCR either with the standard formula or an internal model.
- Second, supervisors shall acquire information on group-specific risks through, among other means, the group supervisory review process (including the ORSA), stress tests, scenario analysis or other quantitative or qualitative measures.
- Third, if the group uses the standard formula and, under the second step it has become clear that there is a significant deviation from the assumptions underlying the standard formula calculation (e.g. due to complex structures, etc.), the group supervisor shall adopt the necessary measures to correct this situation. For this purpose the group supervisor may require:
  a. the use of an internal model pursuant to Article 119; or
  b. the use of group specific parameters for underwriting modules where the deviation arises from the application of those modules.
- Alternatively, if the group uses an internal model, then the requirements of Articles 112 to 126 shall apply meaning that any deficiency due to group specific risks will have to be adressed in the same way as for any other risks.
- Finally, if the group is unable to fulfil the requirements above within an appropriate timeframe[31], the group supervisor, in consultation with the supervisors concerned, may decide as a last resort measure to impose a group capital add-on.

3.5.3. Currency risk when using the standard formula

CEIOPS' advice

3.269. Currency risk at group level needs to take into account the currency risk

[31] See also CEIOPS-CP-57/09 on capital add-on.

towards the currency of the groups consolidated accounts. Therefore, the local currency referred to in the currency risk calculation of the standard formula is the group currency for the calculation for the group SCR.

3.5.4. Group SCR floor

3.270. For the purposes of the accounting consolidation-based method the Level 1 text defines the group SCR floor as a minimum amount of group SCR under which the group SCR cannot drop. This amount is defined in Article 230(2) as follows:

"*The consolidated group Solvency Capital Requirement shall have as a minimum the sum of the following:*
(a) the minimum capital requirement (Minimum Capital Requirement) as referred to in Article 129 of the participating insurance or reinsurance undertaking;
(b) the proportional share of the Minimum Capital Requirement of the related insurance and reinsurance undertakings.

That minimum shall be covered by eligible basic own funds as determined in Article 98(4).

For the purposes of determining whether such eligible own funds qualify to cover the minimum consolidated group Solvency Capital Requirement, the principles set out in Articles 221 to 229 shall apply mutatis mutandis. Article 139(1) and 139(2) shall apply mutatis mutandis"

3.271. CEIOPS gave the reasons for setting a group SCR floor in its previous advices to the European Commission – Call for Advice 18[32] and Consultation Paper 14[33].

3.272. Given the nature of the accounting consolidation-based method, it is most likely that the group SCR will be lower than the sum of SCRs of all insurance undertakings within the group due to diversification effects. It is therefore necessary to ensure that the group SCR is at least above the sum of all Minimum Capital Requirements. Otherwise, the group is only able to comply with solo MCRs by the mean of double use of eligible own funds items or internal creation of capital.

3.273. When using the deduction and aggregation method for the group SCR calculation, it is clear that the group SCR by nature of this method cannot be lower than the sum of solo SCRs as no diversification is recognized.

3.274. The Level 1 text states that the group supervisor, after consultation with other competent supervisory authorities concerned and the group itself, may allow the group to apply a combination of the two prescribed methods for the group SCR calculation. In such case, the group SCR floor defined in

[32] Available at http://www.ceiops.eu/media/files/consultations/consultationpapers/DOC07_05.pdf as part of Consultation Paper 7.
[33] Available at: http://www.ceiops.eu/media/files/consultations/consultationpapers/CP14/CEIOPS-DOC-05-06.pdf

Article 230(2) should only apply to the part of the group covered by the consolidated method i.e. by comparing the sum of the MCR of the entities covered by the consolidated method to the part of the group SCR calculated with that method.

3.275. The solo MCR figure used for the group SCR floor calculation shall be the MCR determined after applying the corridor referred to in Article 129(3) or after applying the absolute floor referred to in Article 129(1)(d).

3.276. Since non-compliance with the group SCR floor inevitably means financial difficulties within the group , it is necessary that the necessary actions at group level are coordinated within the college of supervisors as requested in Article 249(1)(a).

3.277. The calculation of the proportional share set out in article 230(2)(b) shall consider two elements:

a) the part of the contribution to the group SCR of the related undertaking that is covered with own funds of the related undertaking owned/corresponding to the group, and

b) the part of the contribution to the group SCR of the related undertaking that is covered with minority interests when these are included as group own funds.

3.278. Therefore, when the contribution to the group SCR of a related undertaking is fully covered with own funds of the related undertaking (either corresponding group participation or minority interests participations treated as group own funds), the proportional share of article 230 (2b) shall be 100 per cent.

CEIOPS' advice

3.279. The Level 1 text states that the group supervisor, after consultation with other competent supervisory authorities concerned and the group itself, may allow the group to apply a combination of the two prescribed methods for the group SCR calculation. In such case it is not clear whether the group SCR floor should apply. However, to avoid double gearing CEIOPS considers the group SCR floor should be applied when using the combination of both admissible methods. In such case, the group SCR floor defined in Article 230(2) should only apply to the part of the group covered by the consolidated method i.e. by comparing the sum of the MCR of the entities covered by the consolidated method to the part of the group SCR calculated with that method.

3.280. The solo MCR figure used for the group SCR floor calculation shall be the MCR determined after applying the corridor referred to in Article 129(3) or after applying the absolute floor referred to in Article 129(1)(d).

3.281. The calculation of the proportional share set out in article 230(2)(b) shall consider two elements:

a) the part of the contribution to the group SCR of the related undertaking that is covered with own funds of the related undertaking owned/corresponding to the group, and

b) the part of the contribution to the group SCR of the related undertaking that is covered with minority interests when these are included as group own funds.

3.282. Therefore, when the contribution to the group SCR of a related undertaking is fully covered with own funds of the related undertaking (either corresponding group participation or minority interests participations treated as group own funds), the proportional share of article 230 (2b) shall be 100 per cent.

3.5.5. Group technical provisions

3.283. CEIOPS considers that the group best estimate of insurance liabilities should be the sum of solo best estimate of insurance liabilities with only the elimination of the part of the best estimate resulting from internally reinsured activities in order to avoid double counting of commitments as in the consolidated accounts. As at solo level, gross technical provisions shall be calculated at group level.

3.284. The group risk margin is a part of group technical provisions and should be equal to the sum of solo risk margin in any case as it is already calculated net of reinsurance.

CEIOPS' advice

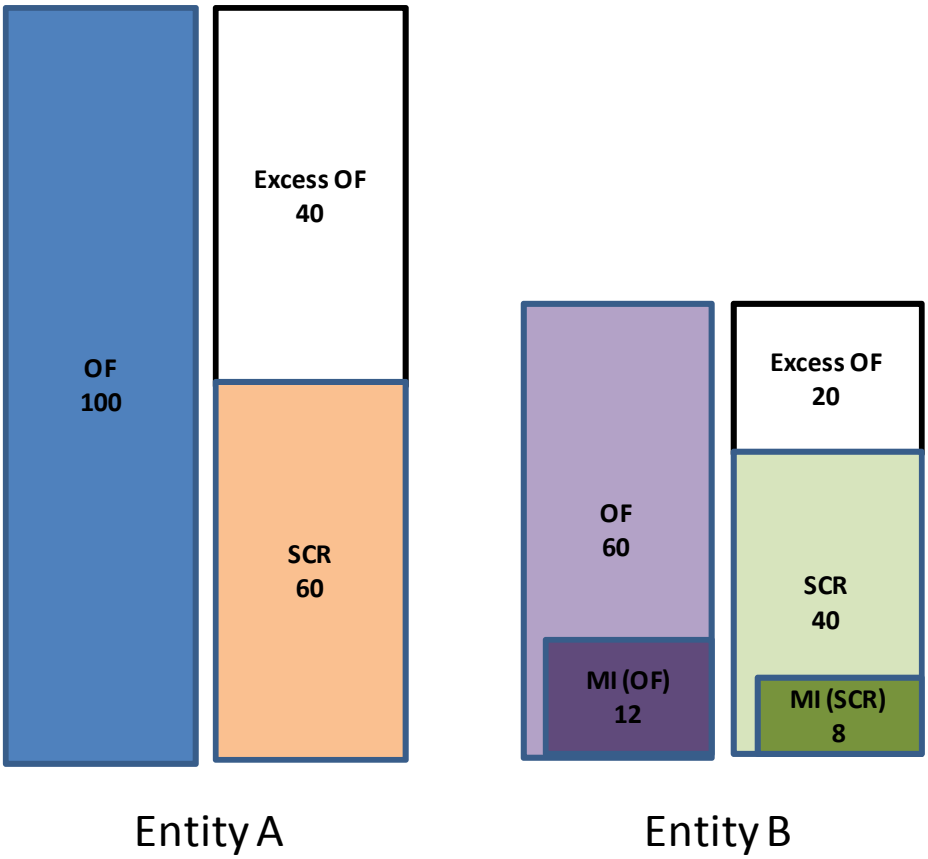
3.285. CEIOPS considers that the group best estimate of insurance liabilities should be the sum of solo best estimate of insurance liabilities with only the elimination of the part of the best estimate resulting from internally reinsured activities in order to avoid double counting of commitments as in the consolidated accounts.

3.286. The group risk margin is a part of group technical provisions and should equal to the sum of solo risk margin in any case as it is already calculated net of reinsurance.

ANNEX 1 ON ELIGIBILITY OF OWN FUNDS

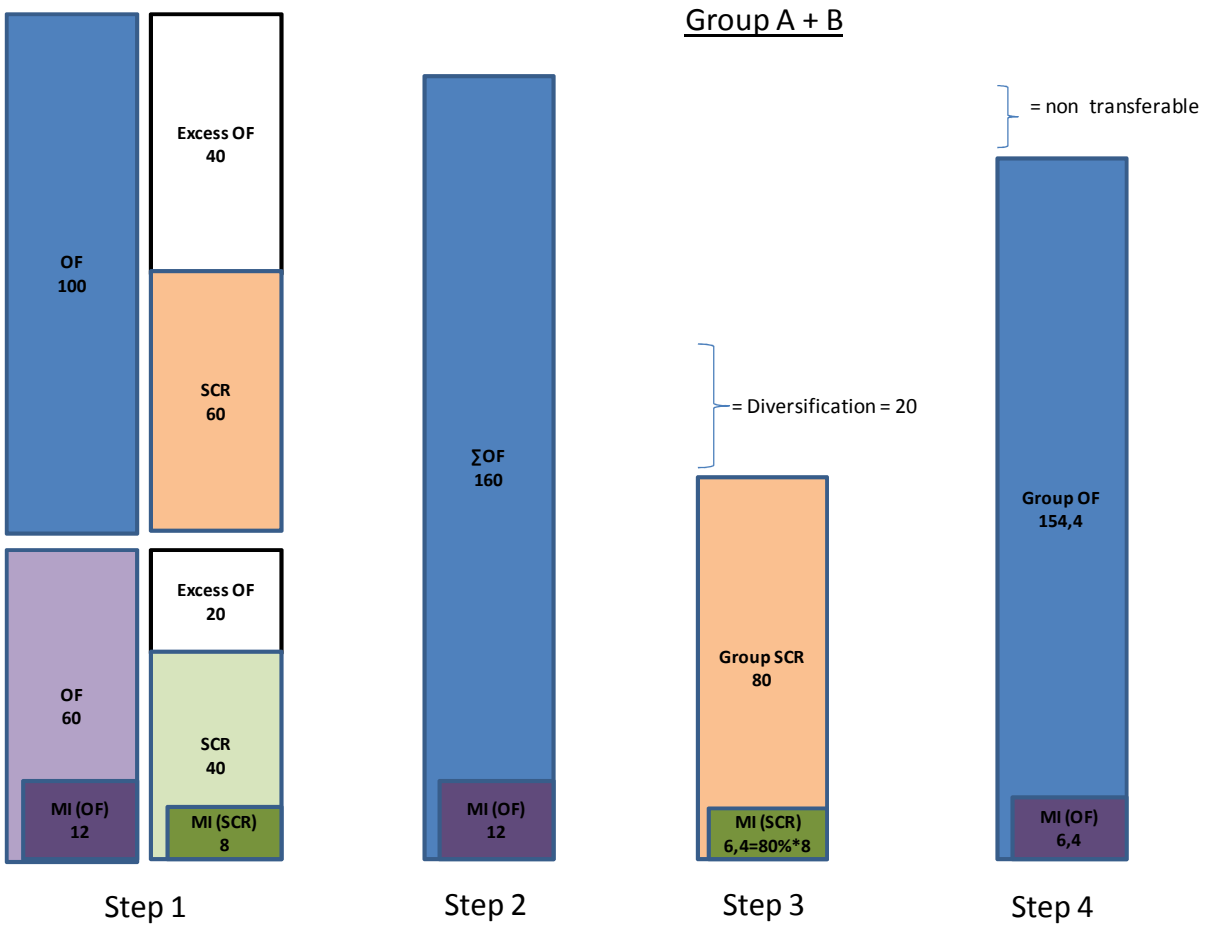
Example on the treatment of minority interests

- A holding owns 100% of A and 80% of B
  - No debt in the holding
  - Value of A = own funds of A
  - Value of B = own funds of B



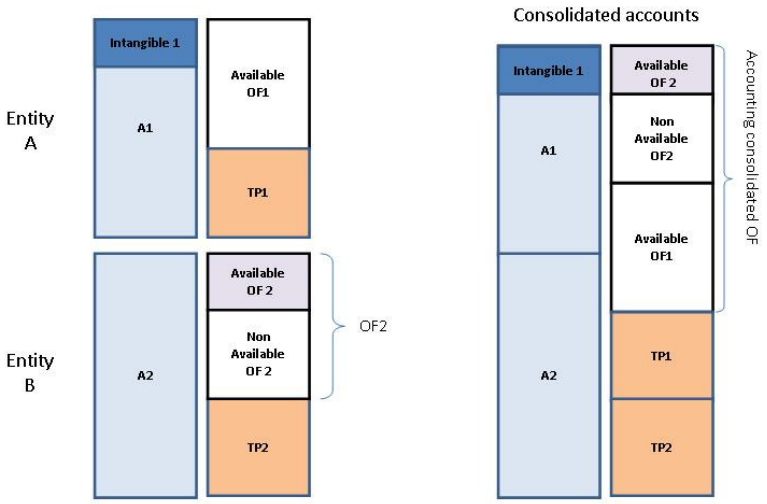
- Solo level (B)
  - Contribution of minority interests in solo OF = minority share in capital x Solo OF = 20% x 60 = 12
  - Contribution of minority interests in solo SCR=minority share in capital x Solo SCR = 20% x 40 = 8
  - Excess Solo OF = Solo OF – Solo SCR = 60 – 40 = 20
- Group level (A + 80% B)
  - ∑OF = 100 + 60 = 160
  - ∑SCR = 60 + 40 = 100
  - Group SCR = 80, Diversification = 20
  - Contribution of minority interest in group SCR = 8 x group SCR / ∑SCR = 8 x 80 / 100 = 6,4
  - Minority interests in consolidated OF = 12 (but only 6,4 are available to cover the group SCR)

- Non available solo OF = 12 – 6,4 = 5,6 (non available to cover the group SCR)
- Group OF = ∑OF – non available solo OF = 160 – 5,6 = 154,4
- Excess Group OF = Group OF – Group SCR = 154,4 – 80 = 74,4
- Excess Group OF = Excess solo OF (A) + [Excess solo OF (B) – Contribution of minority interest in Excess solo OF (B)] + [Diversification– Contribution of minority interest in Diversification]= 40 + [20 – 20%x20] + [20 – 20 x 8 / (60 + 40)] = 74,4

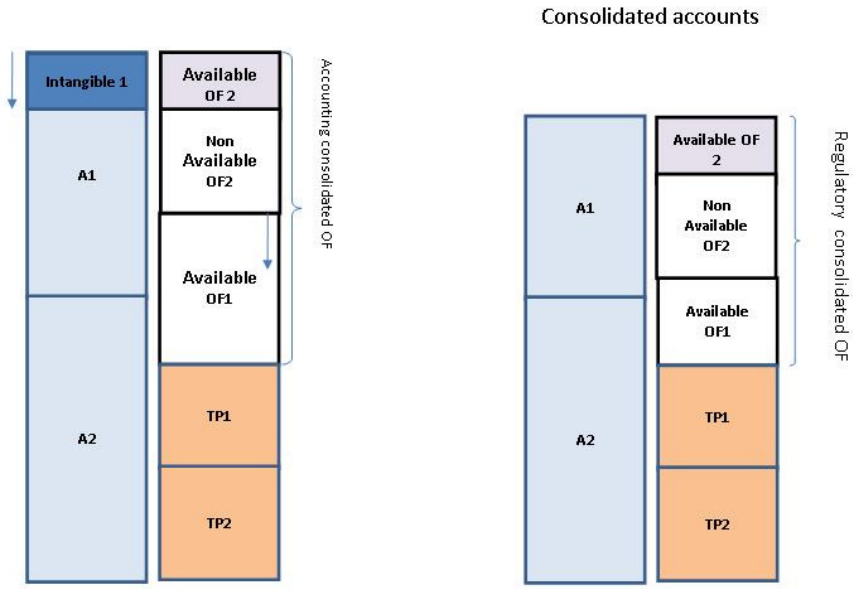


ANNEX 2 ON ELIGIBILITY OF OWN FUNDS

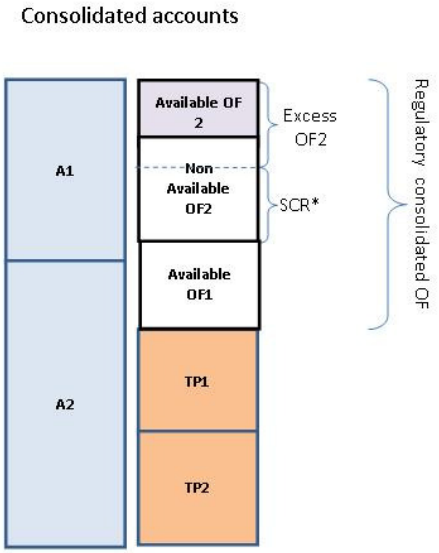
Steps of the calculations of group available own funds



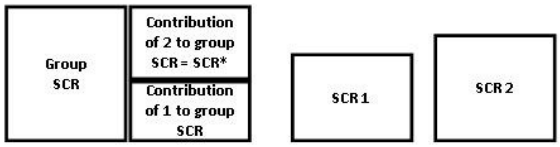
- Step 1 => Accounting consolidated OF = OF1 + OF2



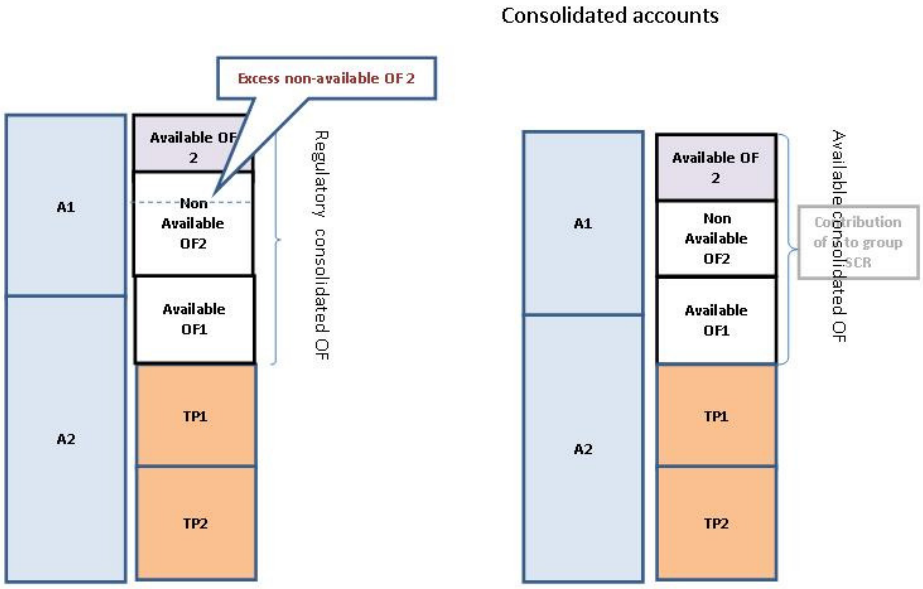
- Step 2=> Regulatory OF = Accounting consolidated OF – Intangible 1



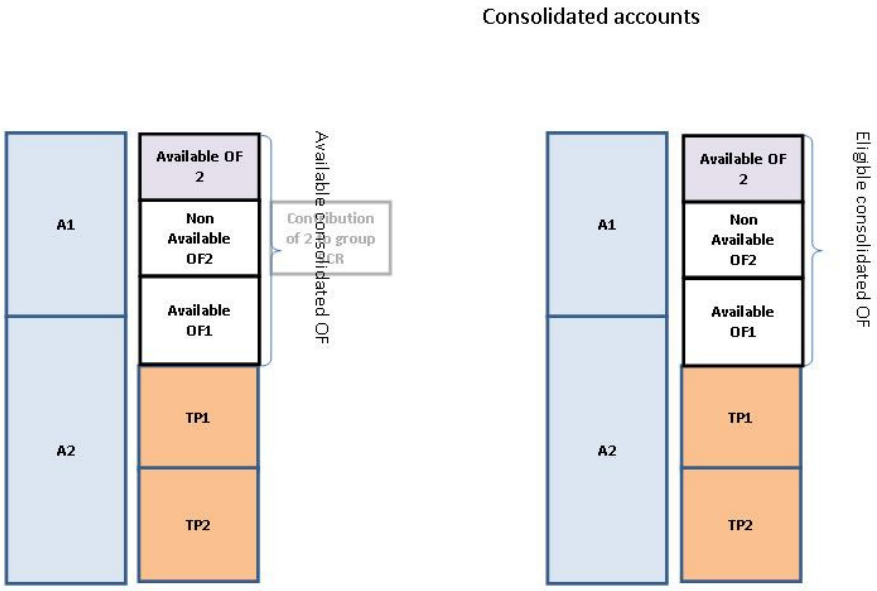
- Step 3 => calculation of Group SCR



Diversification is allocated proportionally to all undertakings to calculate the contributions to the group SCR



- Step 4 => Group OF available = Regulatory OF – Non-Available OF2 in excess of contribution



- Step 5 => Group Eligible OF = Group OF available under Tiers limits criteria

ANNEX 3: extracts of the consolidated accounts directive 83/349/EEC

Article 1

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 each 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
(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 the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if:
(a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking); or
(b) that undertaking (a parent undertaking) and another undertaking (the subsidiary undertaking) are managed on a unified basis by the parent undertaking.

Article 12

1. Without prejudice to Articles1 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.

ANNEX 4: GLOSSARY

"**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 .*

"**parent undertaking**" means *a parent undertaking within the meaning of Article 1 of Council Directive 83/349/EEC29; (article 13 (15)).*

"**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.*

"**subsidiary undertaking**" means any subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC, including subsidiaries thereof (article 13 (16)).

ANNEX 5: proposed treatment of participations under Solvency II

	Type of entity	Type of influence	Treatment in consolidated accounts IAS/IFRS	Treatment in group SCR for consolidated method
1	Regulated (re)insurance undertaking (global)	Dominant	Full integration (including minority interest) (IAS 27, § 22)	In the SF or IM (diversification recognized)
		Jointly share control	Proportional integration or equity value (IAS 31, §30)	In the SF or IM (diversification recognized)
		Significant	Equity value (IAS 28, §13)	No diversification / % of solo SCR
2	Undertakings covered by CRD (credit institutions, investment firms and financial institutions).	Dominant	Full integration (including minority interest)	No diversification / Sectoral requirements
		Jointly share control	Proportional integration or equity value	No diversification / Sectoral requirements
		Significant	Equity value	No diversification / Sectoral requirements
3	IORP	Dominant	Full integration (including minority interest)	No diversification / Sectoral requirements
		Jointly share control	Proportional integration or equity value	No diversification / Sectoral requirements
		Significant	Equity value	No diversification / Sectoral requirements
4	Insurance holding companies.	Dominant	Full integration (including minority interest)	In the SF or IM (diversification recognized and risks included …)
		Jointly share control	Proportional integration or equity value	In the SF or IM (diversification recognized)
		Significant	Equity value [i]	Same at solo
5	Non regulated non financial entities. May include treasury functions.	Dominant	Full integration (including minority interest)	Same at solo
		Significant	Equity value	Same at solo
6	Ancillary insurance services company	Dominant	Full integration (including minority interest)	In the SF or IM (diversification recognized)
		Significant	Equity value	Same at solo