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Dear Ms Faber-Graw

The calculation of group solvency requirements

In this letter Groupe Consultatif sets out our response to the questions you raised in your letter dated 11 December 2008.

Question 1

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

We see the QIS4 approach as a good starting point, since a 'relationship' of control is the key trigger of how participations should be treated. However, a "relationship of commitment (to support)", even when there is no control, has also to be taken into account:

Below we set out an approach that we think should be evaluated: we have not yet been able to make a comparison with other approaches such as that in QIS4. We would be pleased to do so but think this will be best done when any other ideas have been proposed.

We segment a possible treatment as follows:

1. Relationship of full control

Use a look-through approach. Consolidation or deduction-aggregation depends on the situation:

We consider the perimeter of entities which meet two conditions:

- they are fully controlled by a parent entity,
- the capital is transferable among entities within the perimeter (in both directions between each pair of entities).

We believe the aggregation rule could be as follows:

- a. Within this “core group” of entities (including the controlling entity): consolidation,
- b. Outside this perimeter: deduction-aggregation, the “core group” being considered as “one” entity for this second level of calculation.

Here the concept of transferability will need careful consideration. For all entities within the EU, the MCR and SCR are not at first sight transferable; however, as our response to question 2 notes, entities have a value that can be accessed by the group.

The use of deduction and aggregation does not allow for any diversification between the entities nor credit for the value held in regulatory requirements. It assumes that all SCRs will be consumed at the same time whereas the reality is that events will impact each subsidiary in a different way.

2. No relationship of full control

(Note: “no control” does not mean there is “no commitment”)

At first sight one might think:

- share > 20%: Deduction and Aggregation
- share < 20%: treatment as an investment subject to equity risk

Rather than such arbitrary rules we believe it is better to consider the proportionality and materiality principles. The point would be to know whether the underlying risk attached to the entity is a “material” commitment (self-imposed or regulator-imposed) for the group to support the entity in case of difficult circumstances.

- a. if so: use deduction-aggregation.
For each related entity of the group, the percentage of control or commitment should be used. This percentage may be higher than the legal percentage participation of the group in this entity when its part of responsibility/ commitment is bigger (e.g. the other shareholders are all insignificant or “floating”, therefore not committed);
- b. otherwise: equity risk treatment.

3. The rules 2a and 2b may also be applicable to joint ventures where two groups exercise a significant combined control.. We presume that the capital of joint ventures is not transferable to the “parents” in an easy way. The remark developed in 2a would be applicable here as well.
4. Consideration should be given to the burden of working with all the group’s entities on a solo basis and whether prudential objectives could be met using materiality limits and sub-consolidations.
5. Mutuals:

When the parent entity of a group is a mutual company and the other entities are its subsidiaries, the rules developed here above (1a, 1b, 2a, 2b) should apply as well. When a mutual company carries specific fund entities (e.g. non EEA branches, ring-fenced funds in life) from which the capital is not fully transferable to the “parent” fund of this mutual, the above rule 1b should apply to these funds.

The above may not be directly applicable to mutual entities which only have the opportunity to cooperate with other insurance entities in the absence of a presumed control through a stock capital ownership.

When a group is made up of several mutual entities, this group would have to provide evidence that, beyond the relationship of control, the capital is transferable between mutuals.

CEIOPS could set up general guidelines regarding mutual groups such that the same rules as for capitalistic groups would apply. This would be an application of the "substance over form" principle and under the explicit conditions that these groups are able to bring evidence to their supervisors of:

- a full control relationship and
- a full transferability of capital between the mutual entities.

If so, the rule 1a would be applicable;

In the case of full control with no transferability, rule 1b would apply;

In the case of uncertainty regarding the control, there would be no aggregation at all: each mutual entity would perform its solvency test on a stand-alone basis without offsetting the possible "internal" transactions.

6. As a general remark, the framework should avoid cherry-picking of the most advantageous method, i.e. there might be circumstances where the consolidation method yields a better group solvency than the equity investment approach and vice versa. However there should be reasonable flexibility in the choice of method so that another method can be applied if there is the approval of the relevant supervisor.

Note: Here, 'entity' means basically a legal entity (insurance or reinsurance and also a holding). But the concept could also encompass "fund entities" (e.g. ring-fenced fund in life insurance, non-EEA branch). In fact, fungibility and transferability issues exist not only between legal entities but also between "fund entities". We could apply here the "substance over form" principle and consider a group or a solo entity as a group of "fund entities". The principles developed here above would be relevant whatever the legal form of the funds. For example, when an insurance company has one ring-fenced fund, then it can be considered as a group of two fund entities: the ring-fenced fund and the "parent" fund bearing the rest of the balance sheet, including the capital of the company.

Conclusion: The QIS4 approach is a good starting point. It still has to be improved by considering an approach even more "economic" (i.e. "substance over form" principle) and risk-based.

Question 2

Do you think that there are restrictions on group own funds because of limits on the transferability of capital? If so, what are the limitations that impact specific capital instruments?

It is important that the concept of transferability is not drawn too narrowly. If an asset can be sold at some point in time, or transferred, then this asset should have a value and should not be excluded. Of course the present crisis reminds us that any value can be significantly limited in a systemic crisis.

It is advised to take into account limits in diversification effects related to extreme events, for example by the use of tail dependencies. For example, in a separate study, the Groupe Consultatif proposes no, or very limited, diversification between some extreme events and other types of risk such as equity risk. Because of this limited diversification, transferability should be less a problem than often thought.

Possible limits in transferability or no transferability can arise from:

- Part of a group that is situated outside EEA (the other regulator/government can cause transferability problems. Perhaps this is a task for IAIS to consider)
- Within EEA: the MCR (an entity should have some minimum capital available)
- Ring-fenced funds (can perhaps be seen as part of MVL+MCR?)
- Minority interests

Another point to note is that availability of funds within the EU should be assessed against anticipated regulatory practices, and there should not be a need to consider the possibility that EU regulators change the rules during the game.

Regarding the second question, we note the following situations where resources may not be available outside the entity which originates them;

1. Where resources are raised by the issuance of subordinated debt by subsidiary A, the debt instrument may protect the interests of the debt holders by limiting A's ability to transfer assets to the parent or other sister subsidiaries. In this case the eligible own funds represented by the inclusion of an amount equal to the debt will not be available to meet needs outside A. Of course the presence of the resources created in A by the issuance of the debt may allow A to release other funds to the group.
2. Letters of credit and guarantees available to A may not be available to fund other group entities except insofar as they allow A to release other resources and continue to meet its requirements.
3. Ancillary items:
 - member calls may be limited to covering losses on particular books of policies rather than funding deficiencies over the whole mutual including its subsidiaries.
 - unpaid capital is allowed as ancillary capital in A but if called the call would fall on the parent and would not represent any new funds to the group.

The presence of these items in the balance sheet of a part of a group requires careful analysis of the impact on the availability of the resources held to meet needs arising elsewhere in the group. It is not simply a case of whether a particular form of asset or liability (debt) can be counted but how it impacts the availability of all funds to meet policyholder claims as they fall due.

Question 3.

The IAIS in "Issue paper on group-wide solvency assessment" (draft of 18 November 2008) has proposed that:

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

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

We consider that the IAIS definition is a good starting point, but we also believe that the definition for transferability is too narrow. Transferability is not simply “there is” or “there is not”, but also contains a timing effect. Transferring money or value can also cause a loss of value.

We may distinguish three components (in fact, three successive tests) of the concept of transferability:

1. fungibility: at first sight, the IAIS definition looks correct.
2. availability: if the fungibility requirement is met, does entity A has enough capital to support entity B without jeopardizing its own solvency?
3. fluidity: if the availability requirement is met, then practical questions appear: timing, cost of transfer, tax and legal aspects, and capacity to price an asset in extreme circumstances.

Question 4-5-6 (combined)

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

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

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

Key group specific risks not covered in the standard formula

If we consider the difference between a large pan-European insurance company operating across Europe with subsidiaries in each country, with a similar company of the same size operating instead with branches in each country, we can see that the risks are very similar. These risks are not so much a function of the legal structure, as of size and complexity of operation. Many of the risks that are called group-specific are in fact not group-specific, but are “size risks”. Consequently we do not consider the following risks as group-specific, but rather risks that arise as an enterprise becomes larger and more complex.

Reputational Risk

Reputational risk is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions. Reputational risk is very much a function of meeting public expectations, and communication is a vital factor. This risk is common to all enterprises regardless of size, however larger companies tend to be more exposed in the media and thus the extent of the risk can be greater.

Contagion Risk

Contagion is the risk where events in one part of an enterprise provoke events in another part, even if there is no direct link. We should note that this is a significant issue in the banking environment through the run on the bank following investors' loss of confidence. Insurers operate under a different dynamic where a demand for payment by a policyholder requires a claim event. However life insurers are at risk from unanticipated surrenders, particularly where there are guaranteed surrender values and no ability to defer payment. Clearly contagion risk is very much related to reputation risk. Note that this is not a fundamental source of risk but a consequence of risk events. Some internal models will be driven from fundamental risk events and assess the impact consistently across the whole group, including how the events flow through intra group

commitments such as Intra-Group Retrocession. Here this aspect of contagion is therefore integral to the model and does not require additional capital elements.

Concentration risk

Concentration risk is the risk that an enterprise has significant exposures to individual counterparties, groups of related counterparties, business in specific geographical locations, specific products etc. This risk is not really specific for larger enterprises, but in a large complex organisation total exposures can be difficult to measure.

Legal Risk

Legal risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of an organization. Again, legal risk occurs in all undertakings, but the complexity of operations can lead to more exposure, and large enterprises (with "big pockets") can be a target for litigation. Note that legal risk can impinge differently depending on the legal structure, but it is not possible to say if this means that a group is more or less exposed than an enterprise with a large branch network.

Conflict of interest Risk

There could be conflict of interest between local and group interests. This should be controlled by management processes including effective review between entities and group functions.

Note that one theoretical effect of organizing an enterprise as a collection of subsidiaries rather than branches is to mitigate risk. If there is a problem in one subsidiary it is much easier to isolate that problem, and even "walk away" from the problem. Of course in practice reputational considerations would make such a move difficult. Another consideration is the fact that, if an enterprise is a collection of subsidiaries, and the group is experiencing problems, it can be easier to mitigate the problem by, for example, selling off a profitable subsidiary at a book gain. The one area where a group can have a "group-specific" risk is the case where minority shareholders are involved in the subsidiaries. In this case it can be more difficult to react when difficulties are experienced in the group.

Quantitative and qualitative mapping of these risks

The risks mentioned above are all forms of operational risk, and can be treated as such in the analysis of a company's SCR. Quantifying the risks directly is too difficult, but the risks should form an important part of groups ORSA. A suitable tool for analysis would be scenario (/stress) testing

We look forward to further discussion with you on the interesting group issues. Should you have any questions or wish to discuss some aspect our response please contact us.

Yours sincerely



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