SLAUGHTER AND MAY

Slaughter and May Podcast
Solvency II: Group supervision

Robert Chaplin	Hello and welcome. I'm Robert Chaplin, one of Slaughter and May's corporate insurance partners. With me is Beth Dobson, our insurance practice support lawyer. This is our overview of the group solvency and group supervision rules under Solvency II. For more information please see chapter 14 of our Solvency II App. If you don't already have the App, please email solvency.two@slaughterandmay.com to request access. Group solvency and group supervision rules recognise the potential impact on an insurance undertaking of the solvency position and actions of other undertakings within the same group. In order to protect the policyholders of the solo insurance undertaking, group solvency requirements set standards which must be maintained by the group as a whole. This leads to a number of questions: • first, what is a "group" for Solvency II purposes; • second, what group solvency requirements need to be met and how should they be calculated?; and • third, who should supervise a group when undertakings within the group are established in different jurisdictions.
Beth Dobson	Solvency II recognises four different types of group and applies slightly different rules to each. At its simplest, a group for Solvency II purposes may comprise an insurance undertaking authorised in the EEA which holds a participation in one other insurance undertaking - a "Case 1" group. It also includes: • Case 2 groups, which are corporate groups headed by an "insurance holding company" or a "mixed financial holding company" with its head office in the EEA. An insurance holding company is one which (in broad terms) has as its main business the holding of participations in insurance undertakings, provided at least one of the insurance undertakings is incorporated in the EEA. A mixed financial holding company is, broadly, one with subsidiaries engaged in significant activities in both the insurance and banking or investment services sectors; • Case 3 groups, which are corporate groups headed by an insurance holding company or mixed financial holding company with its head office in a third country, or headed by a third country insurance undertaking; and • Case 4 groups, which are corporate groups headed by a mixed activity insurance holding company. A mixed activity insurance holding company is one which isn't an insurance holding company or a mixed financial holding company but which has at least one subsidiary which is an insurance company authorised in the EEA. Supervision of Case 4 groups is limited to supervision of intra-group transactions.

	An important feature of the rules defining a "group" under Solvency II is the possible existence of multiple Solvency II groups within one overall corporate group. Where a sub-group meets any of the definitions of a Solvency II group, group supervision will in principle apply at the level of that sub-group as well as to any other sub-group or wider group higher up the chain. Where all of the entities in the corporate group are incorporated in the EU, in practice group supervision will usually only be exercised at the highest level within the group.
Robert Chaplin	For complex corporate groups with undertakings in a number of jurisdictions, corporate structures may have a significant bearing on whether a holding company falls within the definition of an "insurance holding company" and whether group solvency rules apply to the entire group or only part of it. Groups which undertake both insurance and non-insurance activities (including insurance distribution activities) may wish to ring-fence their insurance undertakings in a sub-group below an EEA holding company to avoid having to apply Solvency II requirements to the entire group. We have advised a number of clients on this type of structure. There remains the risk that regulators in jurisdictions further up the group may wish to also exercise supervision and this may therefore require some negotiation. It may be possible, depending on the overall nature of the business conducted by the group, to establish that the ultimate parent company is a mixed activity insurance holding company and that the group is therefore not subject to full Solvency II requirements, although it can be difficult to persuade regulators of this designation where there are any material reliances between the insurance undertaking and other companies within the broader group, especially where the carrier relies on an intermediary for business – and there is a desire not to include the intermediary in the S2 group. We have seen the use of offshore holding companies to address this issue in a number of groups.
Beth Dobson	Turning to the group solvency requirements themselves, Case 1 and Case 2 groups are required to calculate a group Solvency Capital Requirement and to hold sufficient group own funds to meet that capital requirement. There are two alternative methods for carrying out these calculations. Method 1 is the default method and is referred to as the "accounting-consolidation" method. In principle under this method all the data of the undertakings within the Solvency II group are consolidated and a group SCR and group own funds are then calculated based on the consolidated data as if the group were a solo undertaking. This allows for diversification benefits in the SCR to be recognised across the group. In practice there are various exceptions to the consolidation principle which require adjustments to the group solvency calculation, including: • undertakings which are regulated under another sector, for example credit institutions and investment firms, are included in the group solvency calculation on the basis of their capital requirements calculated under sectoral rules; • non-regulated undertakings are included in the calculation on the basis of the adjusted equity method; and • own funds can only count towards the group SCR in an amount in excess of the solo undertaking's SCR if they can effectively be "made available"

	to the group. There are a number of tests to be met and there is a rebuttable presumption that certain own funds will not be available, including subordinated debt and preference shares.
Robert Chaplin	The alternative group solvency calculation method, known as "Method 2", is an aggregation and deduction method. It can only be used at the request or with the consent of the group supervisor, in circumstances where it would not be appropriate to use Method 1. Groups may request to use Method 2 for part of the group if they have significant operations in a non-EEA jurisdiction which is equivalent for group solvency purposes, as this will allow them to use local rules to calculate the contribution to the group SCR and group own funds of those operations. Third country jurisdictions may be deemed equivalent for these purposes if they have a solvency regime which is equivalent to that which applies under Solvency II. So far only Switzerland and Bermuda have been granted full equivalence, but a number of jurisdictions, including the US and Canada, have been granted "provisional equivalence" for a period of up to 10 years from January 2016. Under Method 2, group solvency is calculated as the difference between (i) the aggregated group eligible own funds and (ii) the value in the participating undertaking of the related undertakings, plus the aggregated group SCR. The main disadvantage of Method 2 is that it does not allow for the recognition of diversification benefits on an intra-group basis. The rules regarding undertakings regulated under other sectors and availability of own funds apply equally to Method 2 as to Method 1.
Beth Dobson	The nature of the group supervision of Case 3 groups – i.e. ones where the group is headed by a non-EEA entity - depends on whether or not the parent undertaking is incorporated in a jurisdiction which is deemed to be "equivalent" for the purposes of group supervision. If the parent undertaking is in an equivalent jurisdiction, Member States must rely on the equivalent group supervision exercised by the third country supervisory authority. So far, only Switzerland and Bermuda have been found to be equivalent for these purposes. It should be noted that Member States do still have the option of exercising group supervision at the level of an EEA sub-group in these cases, although EIOPA guidance suggests that this should be waived if it would result in more efficient supervision. For a Case 3 group headed by a parent undertaking in a non-equivalent jurisdiction, the relevant group supervisor can attempt to apply the group solvency requirements "mutatis mutandis", with the obligation for ensuring compliance resting on the EEA subsidiary insurance undertaking, or it can apply "other methods". Other methods might include requiring the establishment of an EEA insurance holding company and applying group supervision at the level of that sub-group only, potentially with restrictions on transactions between the sub-group and the wider global group. Alternatively, the EEA group supervisor may put in place monitoring arrangements in respect of the wider group. The PRA has, for example, issued modifications by direction in respect of US parented insurance groups requiring: • provision to the PRA of regulatory reports prepared in respect the US group;

	• notification of proposed dividend payments or other extractions of capital from the EU to the US group; and • notification of material changes in governance arrangements in respect of the US group.
Robert Chaplin	Following the end of the Brexit Transition Period, the UK will be a third country for the purposes of EU group solvency and group supervision rules. It is also expected that the UK regime will treat EU jurisdictions as third countries for these purposes. The UK has stated that current EU equivalence decisions will be incorporated into UK law but no decision has been made as yet as to the UK's treatment of EU Member States or the EU's treatment of the UK for equivalence purposes after the end of the transition period. This brings us to the end of this podcast but if you have any questions about groups, please get in touch with either of us or your usual contact at Slaughter and May.