



Solvency Assessment and Management: Pillar I Sub Committee

Insurance Groups Task Group

Discussion Document 110 (v 4)

Intragroup Transactions: Intragroup Support Measures

1. INTRODUCTION AND PURPOSE

This document provides research, views and recommendations in terms of intragroup support measures (“IGSM measures”) also known as intragroup support arrangements:

The base documents used as reference and starting points are:

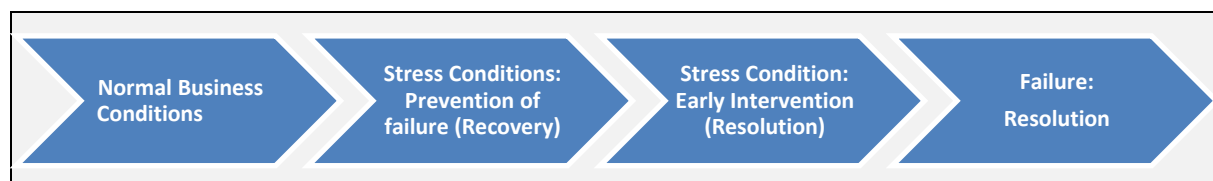
- Position Paper 1: Insurance Groups (Interim)
- Position Paper 81: Interim Governance Measures

IGSM measures are important to be considered by the Regulator as these measures can assist and also complicate the recovery process of Insurance Group in the event of distress and/or failure.

Insurance Groups which failed in a crisis had to consider whether to support a subsidiary or related entity. These decisions largely hinges on the potential damage to the group. The level of intra-group support and interconnectedness of entities within a group affects the extent to which the failure of one entity raises contagion risk for other entities within the group. It also increases supervisory challenges.

The purpose of this document is to provide a better understanding of the use of IGS measures. It addresses the requirements and criteria for intra-group support measures to be recognised as eligible Own Funds at group level during events of distress.

The use of intra-group support measures are part of the Recovery and Resolution framework for Insurance Groups. The term "recovery" is taken to cover actions undertaken by the institution itself in order to overcome financial or operational problems and restore its viability. "Resolution" refers to actions undertaken by authorities if the problems cannot be overcome with recovery or other measures, and failure to act would jeopardise financial stability, prevent the continuity of any critical financial services, lead to the destruction of value and increase costs for taxpayers. In terms of a Recovery and Resolution Framework IGS measures will form part of the Recovery process. Below is a pictorial view of the phases of Recovery and Resolution:



- Prevention - Which includes requirements for recovery and resolution plans, the removal

- of obstacles to resolvability and intra-group support arrangements;
- Early Intervention - Which includes the power for the Regulator to intervene in the activities of a struggling institution; and
- Resolution - Which includes rules for the relevant authorities to take certain actions using one or more '*resolution tools*' to resolve institutions which have failed or are likely to fail in order to minimise systemic impacts and recourse to taxpayer funds.

2. INTERNATIONAL STANDARDS: IAIS ICPs

2.1. IAIS: INSURANCE CORE PRINCIPLES

The following sections from the IAIS principles are relevant and/or informative to Intra Group Support Measures

2.1.1. ICP 10: Preventive and Corrective Measures

Principle:

ICP 10: The supervisor takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.

Standard:

ICP 10.4: If necessary, the supervisor requires the insurer to develop an acceptable plan for prevention and correction of problems. Preventive and corrective plans include agreed and acceptable steps to be taken to resolve the issues raised within an acceptable timeframe. Once preventive and corrective plans have been agreed to or imposed, the supervisor periodically checks to determine that the insurer is complying with the measures.

ICP 10.6: The supervisor initiates measures designed to prevent a breach of the legislation from occurring, and promptly and effectively deals with non-compliance that could put policyholders at risk or impinge on any other supervisory objectives.

2.1.2. ICP 11: Enforcement

Principle:

ICP 11: The supervisor enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.

Standard:

ICP 11.1: The supervisor has the power to enforce corrective action in a timely manner where problems involving insurers are identified. The supervisor issues formal directions to insurers to take particular actions or to desist from taking particular actions. The directions are appropriate to address the problems identified.

ICP 11.2: The supervisor has a range of actions available in order to apply appropriate enforcement where problems are encountered. Powers set out in legislation should at a minimum include restrictions on business activities and measures to reinforce the financial position of an insurer.

11.2.1 At a minimum, the supervisor should have the power to issue the following:

- directions to reinforce financial position

- requiring measures that reduce or mitigate risks
- requiring an increase in capital

2.1.3. ICP 16: Enterprise Risk Management for Solvency Purposes

Principle:

ICP 16: The supervisor establishes enterprise risk management requirements for solvency purposes that require insurers to address all relevant and material risks.

Standard:

Enterprise risk management framework - risk identification and measurement

ICP 16.1: The supervisor requires the insurer's enterprise risk management framework to provide for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of the risks the insurer bears and adequate for risk and capital management and for solvency purposes.

Guide:

ICP 16.1.19 Group risk may arise, for example, through contagion, leveraging, double or multiple gearing, concentrations, large exposures and complexity. Participations, loans, guarantees, risk transfers, liquidity, outsourcing arrangements and off-balance sheet exposures may all give rise to group risk. Many of these risks may be borne by stand-alone insurance legal entities and are not specific to membership of a group. However, the inter-relationships among group members including aspects of control, influence and interdependence alter the impact of risks on group members and should therefore be taken into account in managing the risks of an insurance legal entity that is a member of an insurance group and in managing the risks of that insurance group as a whole. To be effective, the management of insurance group risk needs to take into account risks arising from all parts of an insurance group including non-insurance entities (regulated or unregulated) and partly-owned entities.

ICP 16.1.21: The ERM an insurance group should address the direct and indirect interrelationships between its members. The more clearly-defined and understood such relationships are, the more accurately they can be allowed for in the group-wide solvency assessment. For example, legally enforceable capital and risk transfer instruments (CTRL) established between insurance group members may help to establish the integrity of the insurance group and the effectiveness of its ERM framework for group-wide solvency assessment purposes.

ICP 16.1.22: Assumptions that are implicit in the solvency assessment of an insurance legal entity may not apply at an insurance group level because of the legal separation of insurance group members. For example, there may be few constraints on the fungibility of capital and the transferability of assets within an individual insurance legal entity. An assumption of full fungibility may be appropriate for such an insurer. However, such constraints may feature much more prominently for an insurance group and may, for example, restrict the degree to which benefits of diversification of risks across the group can be shared among group members. Such constraints should be taken into account in both the insurance group's and the insurance legal entity's ERM frameworks

Standard:

Own risk and solvency assessment (ORSA) - continuity analysis

ICP 16.15 The supervisor requires:

- The insurer, as part of its ORSA, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements;
- The insurer's continuity analysis to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements.

Guide”

Additional guidance for insurance groups and insurance legal entities that are members of groups

ICP 16.15.10: An insurance group should also analyse its ability to continue in business and the risk management and financial resources it requires to do so. The insurance group's analysis should consider its ability to continue to exist as an insurance group, potential changes in group structure and the ability of its members to continue in business.

An insurance legal entity's continuity analysis should analyse the ongoing support from the group including the availability of financial support in adverse circumstances as well as the risks that may flow from the group to the insurance legal entity. Both the insurance legal entity and an insurance group of which it is a member should thus take into account the business risks they face including the potential impact of changes in the economic, political and regulatory environment.

ICP 16.15.11: In their continuity analysis, insurance groups should pay particular attention to intra-group cash flows, i.e. whether the insurance group will have available cash flows (e.g. from surpluses released from long-term funds, dividends from other subsidiaries, etc) and whether they will be transferable among group member entities to cover any payments of interest or capital on loans, to finance new business and to meet any other anticipated liabilities as they fall due. Insurance groups should outline what management actions they would take to manage the potential cash flow implications of a stress scenario (e.g. reducing new business, cutting dividends, etc).

ICP 16.15.12: The insurance group's continuity analysis should also consider the distribution of capital in the insurance group after stress and the possibility that subsidiaries within the insurance group may require recapitalisation (either due to breaches of local regulatory requirements, a shortfall in economic capital, or for other business reasons). The assessment should consider whether sufficient sources of surplus and transferable capital would exist elsewhere in the insurance group and identify what management actions might need to be taken (e.g. intra-group movements of resources, other intra-group transactions or group restructuring).

2.1.4. ICP 12 Winding-up and Exit from the Market

Principle:

ICP 12: The legislation defines a range of options for the exit of insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with insolvency of insurance legal entities. In the event of winding-up proceedings of insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimising disruption to the timely provision of benefits to policyholders.

Standard:

ICP 12.0.4 Where an insurer is a member of a group, there could be intra-group transactions and guarantees among the insurer and other group entities. In such cases, in the winding-up of an insurer, the supervisor should cooperate with other involved supervisors to ascertain orderly resolution where possible. For additional information on supervisory cooperation, see ICP 25 Supervisory Cooperation and Coordination.

2.1.5. ICP 17: Capital Adequacy

Principle:

ICP 17: The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.

Standard:

ICP 17.3: The regulatory capital requirements include solvency control levels which trigger different degrees of intervention by the supervisor with an appropriate degree of urgency and requires coherence between the solvency control levels established and the associated corrective action that may be at the disposal of the insurer and/or the supervisor.

Guide:

ICP 17.3.10: Group-wide solvency control levels may trigger a process of coordination and cooperation between different supervisors of group entities which will facilitate mitigation and resolution of the impact of group-wide stresses on insurance legal entities within a group. Group-wide control levels may also provide a trigger for supervisory dialogue with the group's management.

Standard:

ICP 17.5: In the context of group-wide capital adequacy assessment, the regulatory capital requirements establish solvency control levels that are appropriate in the context of the approach to group-wide capital adequacy that is applied.

Guide:

ICP 17.5.4: The establishment of a single group-wide MCR might also be considered and may, for example, trigger supervisory intervention to restructure the control and/or capital of the group. A possible advantage of this approach is that it may encourage a group solution where an individual insurer is in financial difficulty and capital is sufficiently fungible and assets are transferable around the group. Alternatively, the protection provided by the supervisory power to intervene at individual entity level on breach of an insurance legal entity MCR may be regarded as sufficient.

Standard:

ICP 17.9: Any variations to the regulatory capital requirement imposed by the supervisor are made within a transparent framework, are appropriate to the nature, scale and complexity according to the target criteria and are only expected to be required in limited circumstances.

Guide:

ICP 17.9.4: Any variations made by the supervisor to the regulatory capital requirement calculated by the insurer should be made in a transparent framework and be appropriate to the nature, scale and complexity in terms of the target criteria. The supervisor may, for example, develop criteria to be applied in determining such variations and appropriate discussions between the supervisor and the insurer may occur. Variations in regulatory capital requirements following supervisory review from those calculated using standardised approaches or approved more tailored approaches should be expected to be made only in limited circumstances.

Standard:

ICP 17.10 The supervisor defines the approach to determining the capital resources eligible to meet regulatory capital requirements and their value, consistent with a total balance sheet approach for solvency assessment and having regard to the quality and suitability of capital elements.

2.1.6. ICP 23: Group-wide Supervision

Principle:

ICP 23: The supervisor supervises insurers on a legal entity and group-wide basis.

2.2. THE JOINT FORUM

Below are direct extracts from the Joint Forum's report published in February 2012 regarding the scope of Intra-Group Support Measures.

2.2.1. Definition of intra-group support measures

Intra-group support consists of various types of support measures, **in particular capital and liquidity** support measures, extended between entities within a group **in times of stress or unexpected loss**.

1. For the purpose of the study, intra-group support measures were
 - legally enforceable commitments for financial assistance or assurance made by one group entity (usually a parent) upon which another group entity (usually a subsidiary) can call *in times of stress or unexpected loss*; or
 - commitments which regulators would regard as reliable means of support.
2. These measures typically increase the **risk of loss to the provider** when called upon by a beneficiary that subsequently fails.
3. Support measures can vary between jurisdictions due to differing
 - regulatory,
 - legal or
 - tax regimes.
4. Support measures can stem either from
 - contractual agreements or

- as a matter of law or
 - regulation.
5. They can take the form of
- ongoing or
 - contingent support, secured or unsecured,
- within national boundaries or cross-border.
6. These intra-group support measures may exist between
- regulated entities or
 - between regulated and unregulated entities
- and can take place on a cross-sectoral basis.
7. The direction of support may also vary in relation to the hierarchy of the group's legal control structure.
8. Support provided by a subsidiary to its parent is referred to as “upstream” support whereas support provided by a parent to its subsidiary is referred to as “downstream” support.
9. Differing regulations related to intra-group support measures and the varying types of contractual agreements determined by specific market practices and/or business models have resulted in a broad range of intra-group support measures across financial groups.

2.2.2. Concerns relating to intra-group support

The importance and variety of intra-group support measures within financial groups has increased the supervisory challenges of ensuring that regulated entities and their stakeholders are protected from risks arising from the use of such support measures. In general, supervisory concerns arise when intra-group support measures:

- result in capital, income or assets being inappropriately transferred from the regulated entity, or result in intra-group creation of capital resources (ie double or multiple gearing);
- are used as a substitute for financial resources (eg using a guarantee or loan rather than capital held at the subsidiary);
- are implemented on terms or under circumstances which third parties would not accept;
- adversely affect the solvency, liquidity and profitability of individual entities within a group;
- result in contagion risk, thereby precipitating knock-on effects on financially sound entities when one entity within the group experiences stress;
- complicate group structures and therefore obscure the supervisor's view of the group and/or legal entities that operate within their jurisdictions, thus affecting both the ability to supervise on an ongoing basis, and resolution and recoverability; and
- are used as a means of regulatory arbitrage to evade capital or other regulatory requirements altogether.

There may however be positive aspects to intra-group support measures as they can provide financial resilience and create a stabilising effect on the wider group.

2.2.3. Intra-group exposures/transactions

Intra-group exposures/transactions take the form of an often complex netting of direct and indirect claims which entities within financial groups typically hold on each other. The most transparent form of intra-group exposure is a credit or a line of credit which either the parent grants to a subsidiary or one subsidiary makes available to another subsidiary. Intra-group exposures, however, can originate in a variety of other ways: for example through

- (a) intragroup cross shareholdings;
- (b) trading operations whereby one group entity deals with or on behalf of another group entity;
- (c) central management of short term liquidity within the group and
- (d) guarantees and commitments provided to or received from other companies in the group.

For the purposes of the report, intra-group support measures should be considered a subset of intra-group exposures/transactions. Wider intra-group exposures/transactions relating to “business as usual” activities are not considered to be intra-group support measures. Instead this paper focuses on intra-group support measures that are put in place in times of stress or unexpected losses.

Wider intra-group exposures/transactions not captured by this narrower definition of intragroup support may be put in place for the following reasons:

- to promote the development of group business activities (eg facilitate acquisitions, integration of acquired business, distribution arrangements, internal restructurings, sales or other disposals of assets or businesses or similar transactions);
- to enable the group to operate on an integrated basis across different legal entities, some of which may not be in the same jurisdictions;
- to support entity credit ratings in a group (eg parental support of an entity in order to obtain the same credit rating as the parent entity) and therefore ensuring competitive financing terms for entities of the group;
- to promote efficient use and fungibility of the group’s capital resources across the different legal entities; and
- to manage and provide liquidity and capital resources across the group.

Notwithstanding their economic and commercial benefits, both intra-group exposures/transactions and support measures have the potential to adversely affect the solvency, liquidity and profitability of individual entities within a group. They can impede effective supervision and resolution efforts, and increase contagion risk across the group.

Gathering information on existing “business as usual” intra-group exposures/transactions was not an objective of this study. However, it should be noted that making a clear separation between intra-group exposures/transactions and intra-group support measures was not always possible in practice. For this reason, “business as usual” intra-group exposures/transactions were considered to the extent that they might change materially or be extended in times of stress or unexpected loss (thus becoming forms of “intra-group support” as defined for this study).

2.2.4. Key Findings: General

- Responses illustrated a varying understanding of the term “intra-group support” as certain firms provided information on “intra-group exposures” more generally rather than on intragroup support-measures.

- A *measure* can be part of normal business practices, but can also become a support measure in a financial crisis (eg the extension of a credit line). As such, intra-group exposures that are likely to become a support measure in times of stress were given consideration.
- *Measures* differ per insurer and are a crucial part of the management function and *measures* are mainly a choice between guarantees, loans and equity injections. Please see section 2.2.6 for a more comprehensive list.
- A key factor to consider is whether the groups manage capital and liquidity on a centralised basis or whether each entity manages in a self-sufficient or self-contained manner. The model chosen impacts the nature and design of *intra-group support measures*.
- Insurance groups and conglomerates use internal group reinsurance, however, due to the nature of reinsurance, it was not considered a *support measure* for the purposes of the study as it is generally called upon only when certain events specified in the contract materialise and generally not when other stressful events occur.
- Internal support *measures* generally were found to be provided on a one-way basis (eg downstream from a parent to a subsidiary).
- The groups included within the survey generally operate across borders and, as such, stated that their support *measures* were provided domestically as well as internationally.
- Support *measures* also take place between regulated and unregulated entities

2.2.5. Key Findings: Centralised and decentralised capital and liquidity management: **Centralised capital management**

- Respondents stated that central liquidity management enabled their groups to prepare for and mitigate various risks to the group's liquidity position. They noted that this ensured sufficiently high liquid assets at all times in the event of potential liquidity outflows under both normal and stress conditions, including acute stress conditions (eg in the case of a potential downgrade of the credit rating at the parent or local level).
- Certain respondents also explained that cash pooling is important because it can reduce consolidated leverage. It can also reduce the need for third-party placements at the subsidiary level (and the credit risk attached) because the highest rated entity in the group, the parent company, is best positioned to access the most cost-effective funding, provide a single face to the market and effectively manage the relationships with rating agencies and institutional investors. Unlike many of the subsidiaries, the parent also has fewer restrictions on both lending and recouping funding to and from subsidiaries.

Decentralised capital and liquidity management (“subsidiary self-sufficiency”)

- Respondents suggested that soundness of capital and liability pricing at the subsidiary level is critical and that groups operating without it cannot truly understand their cost of resources, making them susceptible to less rational group capital allocation decisions over time. Furthermore, centralisation can result in subsidiaries becoming too dependent on their group parents for other functions (eg risk management and strategic decisions).

Domestic risk models translate the group's risk expertise into a local implementation of risk assessment strategies.

- A key advantage noted by respondents operating self-sufficient subsidiaries was that they allow for easier separation from the rest of the group - for example, in terms of the sale of any particular unit for commercial gain or in situations when it is necessary to isolate an entity during a crisis to limit contagion to the rest of the group.

2.2.6. Specific types of intra-group support measures

The following list provides an overview of the different intra-group support measures used by respondents grouped by financial sector. It should again be noted that a number of these measures, although used for business as usual purposes, are also available for and would be used in periods of stress:

1. Committed facilities (senior loans)
2. Subordinated loans
3. Letter of credit
4. Guarantee
5. Equity injection
6. Bond swaps
7. Bond lending / repo agreement
8. Letter of comfort / Declaration of backing /

2.2.7. Restrictions and regulatory requirements which apply to intra-group support measures

This section outlines firms' perspectives on the main external and internal restrictions and other regulatory requirements which apply to intra-group support measures. The views expressed are not necessarily the views of respondents' supervisors, nor are they necessarily a reliable description of the legal and regulatory frameworks in relevant jurisdictions.

Regulatory and legal restrictions

Respondents indicated that there are legal, regulatory and tax restrictions which could make it difficult to quickly transfer capital or liquidity from a foreign subsidiary to the parent or, more generally, from one affiliate to another. Even international transfers to and from branches may be restricted. One respondent stated that in contrast, downstream capital transfers from the parent to the subsidiary can usually be accomplished comparatively quickly and with significantly lower obstacles.

One respondent specified that the memorandum and articles of association (or equivalent) and applicable law will determine whether support can be provided. The firm also stated that regulatory restrictions – for example, large exposure and capital adequacy provisions – will limit the extent to which support can be extended.

One group noted that the majority of its intra-group support (including loans, letters of credit, etc) was put in place as capital support to meet regulatory requirements.

Concentration limits and restrictions on upstream guarantees between banking subsidiaries

Respondents indicated that in some jurisdictions a banking parent can easily and almost without limit support its subsidiaries provided the parent continues to meet its liquidity

standards. However, banking subsidiaries face legal lending limits on the amount of liquidity they can upstream to their parent even when they have excess liquidity.

Certain respondents claimed that these legal lending limits are inefficient when managing the liquidity and funding position of a banking group overall and advised that they expect future banking regulation to further institutionalise these inefficiencies. As such, in their view, subsidiaries will need a liquidity buffer for their own positions that the greater group is not able to use.

As a general rule, almost all of the respondents stated that they were subject to severe legal restrictions in their ability to upstream, except in certain specific jurisdictions. For example, French law requires that an affiliate receive real and adequate benefit in proportion to the risk assumed and that it remains solvent after the upstream transaction.

Concentration limits and restrictions on upstream guarantees between banking and insurance subsidiaries

According to one respondent, insurance entities face concentration limits when providing funding to affiliated banking entities, however, in principle no concentration limits apply to the investment policy of own funds of an insurer.

One group stated that any arrangement (eg senior loans) between a bank entity of the group and a non-bank affiliate have to be collateralised according to US Regulation W.

According to respondents thin capitalisation rules generally limit the amount of tax efficient funding an entity can receive from its parent. When funding of an entity exceeds a given threshold relative to its capital enabled by the entity's heavy reliance on parental guarantees, funding costs are treated less advantageously from a tax point of view (as the deemed excess may economically be viewed as capital rather than funding in nature).

Large exposure rules and lending limits

Large exposure rules are seen by some as limiting the extent of intra-group transactions, particularly in Europe. One European respondent noted that the large exposures regime it was subject to restricted some intra-group exposures to 25% of their capital base, both at the solo and consolidated level. Certain respondents claim that certain subsidiaries have significant excess liquidity which cannot be used elsewhere in the group. Also certain respondents stated that regulated entities are subject to large exposure rules, but generally the potential recourse to these entities from intra-group transactions remains far beyond the applicable regulatory limitations.

One large cross-border group noted that its home regulator restricts the amount of crossborder exposures to certain countries. This respondent noted that since the group has subsidiaries incorporated and operating in certain of these countries, such geographic controls create an additional constraint on intra-group exposures. It further stated that at a time of increased pressure due to cross-border business growth, it is important for utilisation levels to be periodically reviewed in order to ensure the total exposure remains within limits, and that unnecessary intra-group cross-border country risk exposure is avoided.

One respondent claimed that, in their view, large exposure rules limit the optimal provision of committed credit facilities from one affiliate to another within a group and force the use of sub-optimal parent-subsidiary legal structures.

In the insurance sector, one respondent mentioned that each insurance regulatory domicile has inter-affiliate lending limits beyond which regulatory approval is required. Generally the borrower and the lender are subject to a test on prior year-end general admitted assets, and if exceeded, would require prior regulatory approval.

Minimum capital requirements

Banking subsidiaries around the world are subject to supervision and regulation based on, among other things, minimum capital requirements. The obligation to satisfy capital requirements is seen by certain respondents as affecting the ability of banking subsidiaries to transfer funds to the parent in the form of cash dividends, loans or advances. In addition, under the laws of various jurisdictions where subsidiaries are incorporated, dividends may only be paid out of legally available funds. Even where minimum capital requirements are met and funds are legally available, the relevant regulator could advise against the transfer of funds to the foreign parent in the form of cash dividends, loans or advances, for prudential reasons or otherwise.

Corrective action

Two insurance groups noted that corrective actions would be triggered in their jurisdiction when there is a breach of minimum regulatory requirements or certain net worth maintenance levels. Under the US insurance risk-based capital system, an individual company's capital and surplus may reach a level of impairment that triggers mandatory company actions (known as "Company Action Level"). At the Company Action Level, an insurer is required to submit a report to the regulator within specified time periods outlining a comprehensive financial plan that identifies the conditions that contributed to the company's financial condition. The plan must contain proposals to correct the financial problems and provide projections of the financial condition, both with and without the proposed corrections. The plan must list the key assumptions underlying projections and identify the quality of, and the problems associated with, the insurer's business. If a company fails to file this comprehensive financial plan the Regulatory Action Level is triggered. However, insurance risk-based capital standards do not mandate actions by other members of a group in support of subsidiaries or affiliates.

Excluded persons

Legislation in one jurisdiction ensures that an insurance company shall not transact under unusual conditions with specified persons or entities affiliated to the company: a major shareholder, its holding company or other related persons.

Internal restrictions of the financial groups

Intra-group transactions are not only limited by law and regulation but also by internal group procedures and guidelines. Most of the firms that participated in this work stated that they have internal guidelines specifying that any investment exceeding a certain amount must be presented to the Board of Directors or its delegated commission for approval. They also stated that they have general guidelines specifying that any support involving capital must also be approved by an internal committee (eg a committee led by the finance department and comprising representatives from tax, accounting, legal and any other relevant areas).

One respondent noted that all its intra-group support facilities are limited either by the inclusion of an express limit within the documentation or through internal limits that act to restrict the level of business that the obligor is able to undertake. Another respondent stated that it performs the Internal Capital Adequacy Assessment

Process “ICAAP” for its operations in accordance with US regulatory guidance. This process creates stress test scenarios to evaluate the depth and quality of the group’s capital base and includes triggers that are monitored to evaluate the capital adequacy of the firm. The ICAAP provides governance over the process of monitoring the group’s capital base. This group also maintains a Contingency Funding Plan that measures the company’s liquidity profile under a base case and stress scenarios. The plan contains triggers and potential action steps.

Ranking of intra-group claims in the case of insolvency

According to the respondents, in most jurisdictions the ranking of claims of intra-group creditors in the case of insolvency are no different than the ranking of claims of creditors external to the group. Prioritisation of the claim in insolvency depends on the loan’s seniority. Consequently, intra-group senior loans generally rank *pari passu* with other senior loans of the same debtor and, similarly, intra-group subordinated loans generally rank *pari passu* with other subordinated loans of the same debtor. It is also irrelevant whether the claim belongs to a local or foreign creditor. However, there are certain jurisdictions (eg Spain) where certain local bankruptcy or insolvency regulations redefine senior intra-group claims as subordinated claims.

One insurance group stated that subordinated loans by definition rank junior to senior loans, however in practice, senior loans to non-operating holding companies are economically subordinated loans at best as the main assets of these holding companies are equity investments in their operating companies. As such, the holding company must repay the interest and principal on its senior loans with proceeds (ie typically dividends) derived from its investments in the equities of its operating companies.

Another common exception to the normal hierarchy of claims occurs in the case of a secured claim. In this case, it will have a priority claim on the pledged assets or due to the collateralisation mechanism established in the security documentation.

Disclosure requirements

Most of the groups have a duty, to the extent required by IFRS, to disclose intra-group transactions in their consolidated financial statements annually and in certain situations semiannually. Regulated entities of the group party to these transactions may also have to disclose them in their respective statutory accounts generally filed with their local regulators.

One respondent noted differing levels of disclosure, for example, disclosure in group accounts, disclosure in audited accounts of subsidiaries, etc. It noted that support measures such as letters of support and guarantees were disclosed in their audited financial statements, albeit not individually. In one case, the group stated that a guarantee would be disclosed to the board and that counterparties would be made aware of the guarantees, however further detail was not provided.

Another respondent stated that for certain very large amounts of support material to investors in the parent holding company (or any publically traded entities in the group), the decision to provide support to a regulated subsidiary could amount to inside information in relation to the securities issued by the parent holding company (or its subsidiaries). Therefore the firm advised that this requires disclosure of support to the relevant stock exchange(s) without delay.

One respondent also mentioned the need to disclose intra-group support due to Pillar 3 reporting in banking regulations globally.

Another respondent from the US stated that disclosure is required for most intra-group support arrangements, eg disclosures contained in the NAIC Annual Statement blank and in holding company reports that are required to be filed with an insurer's domiciliary state.

Monitoring

Intra-group support measures are not a separately monitored transaction type within firms. However, they are captured and regularly monitored as part of the firms' overall risk management process. The frequency of monitoring varies with the nature of the support measure. For example, measures related to liquidity management are monitored on a daily basis while other measures (eg other loans and collateral) are monitored on a quarterly basis however this varies from group to group.

Certain groups mentioned that monitoring of intra-group support takes place on a centralised basis (eg by group treasury management), and would take place as part of regular regulatory and compliance monitoring. Notably, certain intra-group support measures require sign-off by the board of directors.

Survey conclusions

Intra-group support measures can vary from institution to institution, driven by regulatory, legal and tax environments as well as the management style of the particular institution and the cross-border nature of the business. Authorities should be mindful of the complicating effect of these measures on resolution regimes and the recovery process in the event of failure.

The majority of respondents surveyed indicated centralised capital and liquidity management systems were in place. According to proponents, this approach promotes the efficient management of a group's overall capital level and helps maximise liquidity while reducing the cost of funds. However, the respondents that favoured a "self-sufficiency" approach pointed out that centralised management potentially has the effect of increasing contagion risk within a group in the event of distress at any subsidiaries. The choice of capital management systems impacts the nature and design of intra-group support measures. Some firms indicated that the way they managed capital and liquidity within the group was a key driver in their decisions about the intra-group transactions and support measures they used.

Committed facilities, subordinated loans and guarantees appear to be the most widely used forms of intra-group support instruments. This trend appears to be consistent across sectors and jurisdictions.

Internal support measures generally were provided on a one-way basis (eg downstream from a parent to a subsidiary). Loans and borrowings, however, were provided in some groups on a reciprocal basis. As groups surveyed generally operated across borders, most indicated support measures were provided both domestically and internationally. Support measures were also in place between both regulated and unregulated entities and between entities in different sectors.

While the existing regulatory frameworks for intra-group support measures are somewhat limited, firms do have certain internal policies and procedures to manage and restrict internal

transactions. It is clear from the survey that the regulatory setting can have significant influence over the form in which institutions implement their intra-group support measures.

At the same time, respondents pointed out that the regulatory and legal framework can make it difficult for some forms of intra-group support to come into force while supervisors aim to ensure that both regulated entities and stakeholders are protected from risks arising from the use of support measures. For instance, upstream transfers of liquidity and capital are monitored and large exposure rules can limit the extent of intra-group interaction for risk control purposes. Jurisdictional differences in regulatory setting can also pose a challenge for firms operating across borders.

Concerns related to intra-group support measures described in the Scope section of the report were not all confirmed by the survey. Among the interviewed firms, the Joint Forum found no evidence of intra-group support measures being implemented on terms or under circumstances that third parties would not accept. Some groups in fact pointed out that loans are only provided on an arm's length basis. Similarly, they could find no evidence of support measures leading to capital, income or assets being inappropriately transferred from regulated entities, or resulting in intra-group creation of capital resources.

Taking a closer look at the motivation of participating firms, these firms stated for example that subordinated loans are being used to provide capital support for funding organic growth and acquisitions and several groups stated that the main motivation for the use of guarantees is capital relief for rating agency capital measurement purposes. On the other hand, a good rating reduces the necessity of the parent to provide a subsidiary with liquidity, as the subsidiary is better able to source funds independently at cost-effective levels. Another concern is that intra-group support measures can complicate group structures. Even though certain groups admit this is true, they view it as nonetheless manageable. All of this does not necessarily mean that supervisory concerns relating to intra-group support are not valid - the report is based on industry responses, and it is possible that the groups surveyed did not provide a complete picture of the risks that intra-group support may pose.

Based on the survey and independent of remaining concerns and information gaps, single sector supervisors should be aware of the risks that intra-group support measures may pose and should fully understand the measures used by an institution, including its motivations for using certain measures rather than others. In order to obtain further insight into the intragroup support measures put in place by financial institutions within their jurisdiction, national supervisors should, where appropriate, conduct further analysis in this area. A high-level model questionnaire is provided in Annex II with the aim of assisting national supervisors with ongoing work relating to intra-group support measures.

2.3. Other Regulators

OSFI, Finma and APRA subscribes to the international best practise as set out in the Joint Forum's report published in February 2012 regarding the scope of Intra-Group Support Measures.

In most of these jurisdictions regulators require regular reporting on intra-group transactions. Some authorities limits intra-group transactions or require capital charges for certain intra-group transactions.

In terms of transferability of free funds to other jurisdictions, there are sometimes local regulatory constraints. In the context of capital transferability, groups consider the tax implications as well.

In general OSFI's framework constitutes specific action with regard to intra-group transactions and exposures whereby materiality criteria is set for related party transactions.

For Finma, a general circular specify the minimum reporting on internal business transactions of insurance groups and insurance conglomerates.

The approach of APRA on Intra-group supervision is considered from the perspective of the insurer and the group. A prudential standard are applicable that deals with intra-group transactions and exposures.

However specific information on intra-group support measures could not be found.

2.4. Other research

2.4.1. The EU Crisis Management Directive (CMD)

The EU published a draft proposal for a European Directive establishing a framework for the recovery and resolution of credit institutions and investment firms during 2012.

As part of the scope of the CMD it addresses intra-group financial support. As part of the recovery planning process, members of a financial group will enter into intra-group arrangements to provide, if required, financial support to group entities that are in financial difficulties (e.g., providing loans, guarantees or assets that can be used as collateral), provided that the arrangements are authorised by the Competent Authority responsible for the consolidated supervision of the group. Member States are permitted to impose an additional requirement that the shareholders of a group entity proposing to participate in a financial support arrangement must approve the arrangement in a shareholder's meeting.

The Crisis Management Directive establishes a framework for intra-group financial support by group members in favour of other group entities. The parent company may determine the participating group entities. Support may not be granted without consideration, and the principle of reciprocity applies.

The creation of an intra-group support framework requires an application by the parent company. Any support may not endanger compliance with capital rules, but support measures may be granted notwithstanding any limitations of domestic laws. In this respect these rules do not have equivalents in national laws, e.g., neither German corporate law nor the German Restructuring Act allows such a far reaching intra-group support.

2.4.2. The Geneva Association's Group-wide Risk and Capital Management of Internationally Active Insurance Groups – Practices and Challenges

The paper quote on the issue of transferability:

"In the event of a crisis, the group's ability to transfer excess funds to other locations will depend on several factors, including the nature of the crisis. It is conceivable that regulatory sensitivity to capital transfers may be enhanced during a crisis, with the existing rules rigorously enforced and additional measures introduced to ensure adequate protection to the

“local” policyholders. It would be important therefore to have agreed upon rules of conduct that would bind regulators in terms of crisis.”

With regard to Ring-fencing, with the aim to protect insurance groups from contagion (i.e. risk exposure or operations within a part of the group negatively affecting other parts or the entire insurance group), but also in order to properly allocate financial results to specific business lines one might consider separating financially (“ring-fencing”) certain activities.

This can be done in many different ways including:

- (1) On an administrative basis, where the separation of assets and liabilities mainly refers to separated accounting records in conjunction with rules regarding the risk and capital management (for example: participating funds in certain jurisdictions) and
- (2) On a legal basis, providing for a full legal and financial separation of assets and liabilities held by an entity of the insurance group (for example: certain activities are run within a legal entity of an insurance groups),
- (3) On an analytical basis, where blocks of similar business with similar risks are separated identified, monitored, and subject to scenario testing. Where applicable, specific contingency plans are identified for individual blocks and these mitigate spill-over effects.

Dealing with Contingency capital plans, after 2008, 11 out of the 19 insurance groups interviewed implemented, to different degrees, contingency capital plans in the event of external shocks (i.e. capital market shocks, large-scale catastrophic event). In the U.S groups reported to be legally bound by their supervisor to have such plans.

In general, crisis management responsibilities are taken over by senior management. The crisis management team at group level usually involves the CFO, the CRO and senior company representatives (from affected business units, the risk management department, Treasury, the legal department etc.). This team is supposed to first make proposals to the board of management and after formal approval to execute the contingency plan.

The contingency plan is activated when capital requirements can no longer be met. Some groups in addition use early-warning methodologies, indicating a gradual worsening of the capital situation.

In some cases a contingency plan contains a predefined catalogue of possible capital management measures, e.g.

- Capital (raising/reallocation): through intra-group measures (e.g. capital injection from parent to subsidiary), suspension of dividend payments/share buy-backs, emergency loan agreements in place with external banks, contingency capital, raising of equity or hybrid capital, etc.;
- De-risking of assets: sales of assets, equity participations etc.;
- De-risking of liabilities: business contraction, sale of business blocks or transfer of risk through reinsurance, including alternative risk transfer (ART) and securitisation.

2.4.3. DG Internal Market and Services (“DGIMS”)

This working document sets out a general framework for troubled and failing banks. Seven principle tools were listed as:

- Put prevention and preparation first;
- Provide credible resolution tools;
- Enable fast and decisive action;
- Reduce moral hazard;
- Contribute to a smooth resolution of cross border groups; and

- Ensure legal certainty.

As part of intra-group financial support, a group financial support agreement is considered as a governance measure for intra-group support. The group financial support agreement should be reviewed by the supervisor.

Group financial support should only be provided under a group support agreement if a number of conditions are met and are included in the agreement. These conditions include the following:-

- There is a reasonable prospect that the support provided will redress the financial difficulties of the entity receiving the support;
- The provision of the financial support has the objective of preserving or restoring the financial stability of the group as a whole;
- The financial support is provided for consideration to the entity providing the support by the entity that receives it in accordance with the terms of the agreement;
- The financial support may only be provided if, on the basis of the information available to the management body at the time when the decision to grant financial support is taken, it is reasonably certain that the loan will be reimbursed or the consideration for the support will be paid by the entity receiving the support;
- The financial support may only be granted if it does not jeopardize the liquidity or solvency of the entity providing the support.

Any proposed agreement that has been authorised by the competent authorities must be approved in the shareholders meeting of every group entity that proposes to enter into the agreement. When agreements are approved, the shareholders' meeting of every group entity that will be a party to the agreement must authorise the respective management body to take a decision that the entity will provide financial support. The management body of each legal entity that is party to an agreement that has been approved by the shareholders could report each year to the shareholders or on the performance of the agreement, and on the implementation of any decision taken pursuant to the agreement.

2.4.4. FSA - Enhancing group supervision under Solvency II: A discussion paper

The first chapters of the paper noted six key principles and cornerstones of Solvency II and explained that the document seeks to show how the Commission's proposals implement them in a group context. .

Two of those principles, both fundamental to Solvency II, are:

- a prospective approach to supervision
- trapped capital and the ladder of supervisory intervention at group level

Chapter 4 of the paper highlights the importance for policyholder protection of applying pillars two and three at group level, in order to ensure the college of supervisors focuses on the overview of risks across the group as a whole. The chapter also deals with the question: *"How can these two principles be applied in a group context?"*

The application of both is linked with the respective roles and responsibilities of the group supervisor and the supervisors of subsidiaries under the group support regime, and this aspect is also addressed in the Chapter content provided below:

Application of pillars two and three at group level

The group SCR, although a key element in group supervision, is not the sole means of providing protection to policyholders across the group.

One of the key elements in the preparation of the Solvency II project is the report of the London working party (A conference on Insurance supervision in the EU 2002) on insurance failures. At the heart of that report is the proposition that the quality of risk measurement and management, along with other non-quantifiable elements such as the quality of governance in an undertaking or group, and the strength of its internal controls, are critical to avoiding insurance failures and near-misses.

Increasingly, insurance groups are seeking to achieve enterprise-wide risk management, a holistic concept of risk and capital management which aims to integrate the assessment of risk and available capital for the group as a whole. The framework for group supervision should also have as its starting point the concept that the group is an integrated economic entity, constituted of the undertakings in the group and the economic relationships between them. Clearly it must not ignore the separate legal identities of the undertakings in the group.

The Directive proposal strikes the right balance by applying the pillar one requirements on technical provisions and the MCR at the level of each undertaking, while imposing the SCR as the binding capital requirement at group level and allowing the difference of the SCR and MCR of each subsidiary to be met by group support.

In line with the Impact Assessment executive summary (provided in the paper) Solvency II should adopt an economic approach which promotes alignment of regulatory requirements and industry practice including for insurance groups. It would be far better to acknowledge as a reality the trend in insurance groups towards enterprise-wide risk management and adopt a model for group supervision which works with the grain of this trend.

Further, co-ordinating the application of pillar two requirements and adopting consistent supervisory methods across the group has the potential to contribute significantly to policyholder protection and could reduce costs for the undertakings in the group. The improvement in protection for policyholders would result primarily from an integrated approach to the measurement and management of the group's risks and the resulting oversight which the college of supervisors has in the regulation of the group.

Together these elements amount to a step change in the concept of group supervision, moving away from the solo/supplementary model to a system where the risks in the group including in each of the subsidiaries are assessed using an integrated approach. Among other things this should significantly improve the quality of information that each subsidiary's supervisor has on the solvency condition of the group as a whole. Further, the logical complement to the application of pillars two and three at the level of the group is a strengthened institutional framework for supervisors to develop stronger co-operation.

Prospective supervision and timeliness of intervention

The idea of a prospective approach to solvency is one of the core ways in which Solvency II is different. For example, the concept of the SCR is premised on the undertaking as a going concern and the approach to supervision is required to be "prospective and risk-oriented".

Matching the prospective approach is the requirement for supervisors to intervene in a "timely and proportionate manner". These principles need to be applied in a group context, including to subsidiaries under the group support regime.

There are several elements which together can deliver a sufficiently forward looking approach and ensure timely intervention where there are risks to the financial condition of a subsidiary in the group support regime. These are in summary:

- the requirement to report the risk of non-compliance with:
 - the subsidiary's MCR
 - the subsidiary's SCR
- the requirement to report the risk of non-compliance with the Group SCR
- a proposal for Early-Warning Indicators at a subsidiary level
- the power to require a recalculation of the subsidiary's SCR

First, all undertakings are under an obligation to report not just non-compliance of the MCR but the risk of non-compliance within the **following three months**. This provides a minimum time period to address emerging difficulties in a subsidiary. It is a useful back-stop but arguably not sufficient in itself as a means to ensure a prospective approach to supervision within the group support regime.

The same obligation applies to the risk of breaches of the SCR. Article 238 (Solvency II) requires the supervisor to continue to monitor the subsidiary's SCR but the derogation that the subsidiary's supervisor should not retain the responsibility to enforce the SCR by taking measures at the level of the subsidiary includes the obligation on the subsidiary to report a breach of the SCR, and the risk of a breach within the following three months. However, it is clear that the same reasons for that notification requirement which apply in the case of a solo undertaking also apply in the case of a subsidiary under the group support regime. The sole difference is that it is now also vital for the group supervisor as well to be informed not just if there is an SCR breach but if there is a risk of one in the short-term. **This provides a second element of policyholder protection through the early identification of risks emerging in the subsidiary.**

Within the group support regime the group's financial strength overall is of utmost importance to achieving for each subsidiary the high standards of policyholder protection required by Solvency II. It follows that the supervision of the Group SCR is a key means by which a prospective approach to supervision can be adopted in respect of the subsidiaries in the group support regime.

Together the application by analogy of Articles 134 and 136 provide a key mechanism for operating prospective supervision at group level. One of the suggestions made is that a breach of the group SCR and even the risk of such a breach within the following three months should be a trigger for the college to consider the most appropriate supervisory response.

In addition to the actions triggered by breaches of MCR and SCR at subsidiary level, and of the group SCR, a further element which can make an important contribution to delivering a prospective supervisory approach in the context of the group support regime is **a system of Early Warning Indicators**. All insurance undertakings are exposed to a range of disparate risks but almost always some of those risks are much more significant for the undertaking than others and the patterns of risk salience will vary. One important dimension in the context of cross-border groups is the possibility that certain risks in particular subsidiaries may have more significance or, more likely, change in their significance unexpectedly, and without this being a general phenomenon which would trigger changes in the risk profiles of other entities in the group

It makes sense for the supervisory authorities to agree wherever appropriate a set of Early Warning Indicators for the subsidiaries of the group, paying particular attention to the information they would provide which is specific to each subsidiary. The details of what sorts of information are relevant and their relative importance will be different in each insurance group so logically they are best left to level 3; but some of the kinds of information that might reasonably be considered are listed here:

- significant unexpected changes in technical provisions;
- material changes to risk profile through e.g. new business classes, rapidly
- growing business lines, a changed asset strategy or changes to the
- reinsurance programme;
- large scale changes in senior management and/or internal structure;
- other significant unexpected departures from the business plan;
- unexpected changes in pricing, expenses and profitability;
- outlier results when compared against peers in the local market

Clearly the amount information that could be collected about even a single subsidiary is potentially very large and if an unreasonable reporting burden is imposed this will be almost as much a problem for the college of supervisors as for the insurance group. A good set of Early Warning Indicators would focus on the major risks to the subsidiaries in the group and enable the college of supervisors to have available an oversight of the risks across the group on a consistent basis.

Supposing that an early warning is triggered and as a result the subsidiary's supervisor decides that more detailed assessment of the suspected changes in the risk profile of the undertaking is needed, the optimal response is for the supervisor of the subsidiary to work together with the group supervisor in order to reach a joint decision on how to proceed. This could include requiring the group to recalculate the subsidiary's solo SCR. In the vast majority of such cases it is reasonable to expect that the group supervisor will agree with the concerns raised by the subsidiary's supervisor. However, in the event that there was no shared view, the subsidiary's supervisor clearly retains the power to require a recalculation of the SCR on the grounds of the evidence that the risk profile of the subsidiary has changed significantly since the SCR was last calculated. If the risk profile of the subsidiary has changed materially this will lead to a new value for its SCR and as a consequence the necessary changes to the group support commitment.

Together these elements provide the tools to enable a prospective approach to supervision under the group support regime. However, irrespective of the robustness of systems to enable prospective supervision and to encourage insurers to anticipate adverse events and their impact on the undertaking, breaches of the SCR will occur; of course it takes time for an insurer to respond to financial stress and for supervisors to agree on the proposed response. **The next two sections therefore consider how policyholder protection can be enhanced during the period when an insurance group holds less eligible capital than its group SCR through:**

- The inclusion in the group Own Risk and Solvency Assessment of an evaluation of a group's ability to respond to a breach of the group SCR; and
- The operation of the ladder of supervisory intervention at group level. This is central to supervision of a group in stressed financial conditions.

Financial flexibility at group level

One of the facts about insurance groups which underlies the logic of applying supervision to the group as a whole is that they typically manage risk and capital centrally, in particular the raising of new capital. As a result subsidiaries in an insurance group are typically reliant on the parent company when they are in need of recapitalisation.

A group SCR breach need not trigger the issuance of additional equity or subordinated debt as there are other options available to the group including changing its risk profile or releasing capital through the sale of subsidiaries. Further, until the financial stress which causes a group SCR breach actually occurs, or at least only shortly before, its specific nature and severity are unknown and therefore it is not possible to state with precision what is the most appropriate response. Nevertheless it is possible to envisage the options that are available to a group in the event of a group SCR breach, and how appropriate they may be depending on the size of the breach and the nature of the financial stress. In particular, Article 250 requires that the Own Risk and Solvency Assessment apply at group level; this could readily include an assessment of financial flexibility and the results of this assessment should be shared among all supervisory authorities.

The assessment of financial flexibility makes an additional contribution to applying a prospective approach to supervision at group level. Whether the same requirement should be imposed on a solo undertaking should be a matter for the responsible supervisor. However in a group context where risk and capital management is conducted at group level but ultimately recapitalisation occurs to protect policyholders of the various subsidiaries in the group, it is logical for the group to provide supervisory authorities with an assessment of its capacity to respond to financial stress including where that leads to a breach of the group SCR.

Trapped capital and the ladder of supervisory intervention at group level

As noted at the start of the idea of a ladder of supervisory intervention is fundamental to Solvency II; it is in essence the application of proportionality to instances of non-compliance with the SCR. Policyholder protection is underpinned in normal circumstances by the maintenance of eligible capital at least to the level of the SCR. **But when an insurer suffers significant unexpected losses other means have to be employed on a temporary basis until compliance with the SCR is restored. Those means require in any case more intensive supervision and the provision of a realistic plan to restore compliance with the SCR.**

The group support regime facilitates the operation of the ladder of supervisory intervention at group level. If undertakings in a group are required to hold capital to meet their SCRs separately, own funds held to meet the SCR of a subsidiary which is not suffering financial stress cannot be transferred to support another subsidiary which has experienced unexpected losses. By allowing capital to be transferred between undertakings, the group support regime maximizes the potential that any given quantity of eligible capital held by the group has to provide policyholder protection across the group.

If instead solo/supplementary supervision is applied, because more capital is tied up in the subsidiaries where losses do not occur, **there is no transferable capital available in the group.** In order to provide the same protection to policyholders as the group support regime does, a group regulated under solo/supplementary supervision, with the restrictions on capital transferability it entails, will need to hold additional capital if it wishes to maintain a surplus of transferable capital to absorb unexpected losses across the group. The restriction on holding capital up to the SCR in each subsidiary either increases costs for the group

which are ultimately borne by policyholders or it reduces the group's capacity to absorb unexpected losses.

2.4.5. Basic Capital Requirements (BCR) for Global Systemically Important Insurers - 9 July 2014 - Public Consultation Document

Executive summary

The BCR is the foundation for Higher Loss Absorbency (HLA) together with which it forms a consolidated group-wide capital requirement. The current BCR proposal for endorsement by G-20 in 2014 will apply to G-SIIs only. It serves as a comparable basis for the application of proposed HLA requirements. The IAIS proposes that initially the BCR will be reported on a confidential basis to group-wide supervisors, subject to access by the IAIS for refinement purposes (if relevant).

The development and field testing of the BCR will inform development of the international capital standard (ICS). It is intended that ultimately the ICS will become the foundation for the HLA, at which point the role of the BCR will be reassessed.

The BCR will reflect major categories of risks impacting the businesses of G-SIIs and will account for on- and off-balance-sheet exposures.

Material liability and asset risks are considered. The distinctions between long and short term liabilities are recognised. The focus of the design and development of the BCR is on the risks directly associated with the contingencies insured and other sources of risk for the G-SIIs. It is expected that a more comprehensive approach will be adopted for ICS development. Capital requirements are one of many elements of a full supervisory assessment of the financial condition of G-SIIs and will need to be combined with an evaluation of Qualifying Capital Resources with proper adjustments reflecting specific characteristics of insurance liabilities, as well as other quantitative and qualitative supervisory tools.

Capital Resources

Capital resources are determined on a consolidated basis. However, adjustments are made, when required, to align capital resources with the approach followed for the construction of the BCR Required Capital which takes into account three components: an insurance component; a banking component that applies Basel III qualifying criteria; and a component for other non-insurance financial and non-financial activities not currently subject to sectoral regulatory requirements.

BCR Qualifying Capital Resources may be classified as either core or additional capital. The IAIS is still assessing whether one or both categories of Qualifying Capital Resources will be assessed against the BCR Required Capital. The answer to this question may ultimately depend on the methodology adopted for the application of the HLA requirement. For this reason, two categories of capital are defined and used in this Consultation Document; to provide flexibility with respect to the future application of the HLA requirement.

Treatment of Diversification

The treatment of diversification in the BCR, especially in the context of composite G-SIIs where their life and non-life business may be of similar sizes, has been explored further. While it would be appropriate to reflect the effect of diversification between major risk drivers

in the ICS, the technical complexity of doing so explicitly in the BCR formula is inconsistent with its simple design. As a straightforward approach, the calibration level of the BCR will implicitly account for some degree of diversification.

3. ASSESSMENT OF AVAILABLE APPROACHES GIVEN THE SOUTH AFRICAN CONTEXT

3.1. Discussion of inherent advantages and disadvantages of each approach

N/A

3.2. Comparison of the approaches with the prevailing legislative framework

N/A

3.3. Conclusions on preferred approach

The recommendation below used a combination of information including papers and research from the Joint Forum, the IAIS, the European Commission, the Geneva Association and the Financial Services Authority. The recommendations made in this document are not directly relevant for the Solvency Assessment and Management regime but rather part of a broader financial stability framework. It is expected that the research and recommendations made in the document will form part of the Recovery and Resolution framework of the South African Reserve Bank's Prudential Authority. The recommendations are however important in that it already guides Insurance Groups in terms of what could be considered in terms of the framework and tools in the case that a need arise for an Insurance Group to make use of intra-group support measures for solvency purposes.

3.4. Impact of the approaches on EU 3rd country equivalence

Proposals made are in line with best practice and therefore unlikely to have a negative impact of the EU 3rd country equivalence application.

4. RECOMMENDATIONS

Extracts from relevant Position Papers:

Position Paper 27 – Group Own Funds – states the following regarding intra-group support measures:

“Restrictions:

- *A number of items that will be subject to restrictions when calculating eligible own funds are listed, including among others:*
- *Ancillary own funds*

- *Intra-group support measures, within groups should however be considered in stressed / unusual economic conditions. The support measures are subject to regulatory review and approval.”*

Position Paper 93 – Group Governance – states the following regarding intra-group support measures:

“Capital and Liquidity management requirements for insurance groups:

Capital Management:

-
- *The internal capital planning process must take into consideration the group-wide risk profile and appetite, and the possible negative impacts to its capital position from the material entities and relevant business risks to which it is exposed.*
-
- *The internal capital planning process must determine quantifiable internal capital targets, along with practicable plans for achieving and maintaining these targets under both normal and stressed conditions. This should include processes to alert management of potential breaches.*
- *The internal capital planning process should identify the actions that management is expected to take when its capital position falls below, or is anticipated to fall below, its internal capital target. Different targets should be set for normal and stressed conditions.*
- *The internal capital planning process must take into consideration the availability of capital across entities within the group. This should include the regulatory, legal and other impediments to the transfer of capital across entities, sectors and jurisdictions in which the insurance group operates.*
- ***Intra-group guarantees, potential future injections of capital, and future management actions may not be taken into account in the setting of an internal capital target.***
- *The internal capital planning process must take into consideration the current and forecast business and macroeconomic environment. It should incorporate forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the group’s capital position.*
-
- *All capital management plans must integrate with the large risk management plans in order to ensure the alignment of risk to capital and visa-versa.*

Liquidity:

- *Where an insurance group is part a wider group, timely access to information concerning the wider group’s liquidity position and risks to that liquidity position is required. The head board is required to consider the information and make appropriate decisions including discussing concerns with the regulator.”*

Position Paper 96 - General Stress Testing Guidance for Insurance Companies

“An insurer’s ORSA furthermore requires interaction between its risk management system and its capital management activities. Stress testing should form an integral part of insurers’ internal capital management where rigorous, forward-looking stress testing can identify severe events, including a series of compounding events, or changes in market conditions

that could adversely impact the insurer. This should influence the projections of Own Funds made in the ORSA.”

Position Paper 97 – Group considerations for Stress Testing

“5. CONSIDERATIONS DURING THE PROCESS OF GROUP STRESS TESTING

1. Fungibility of capital

The concept of fungibility is further considered in DD 82. It considers two dimensions, namely transferability and recognition.

1.1 Transferability

The legal and practical ability of the insurance group to transfer capital resources between subsidiaries and the holding entity during times of severe financial stress should be considered. For example, funds available at a group level or in a particular jurisdiction may be seen as being available to transfer to an entity in distress. In severe stressed conditions however, restrictions may be imposed on those assets, making them unavailable to the entity in distress.

Timing

The effect of transferability may be exacerbated by the willingness and ability of a subsidiary to move capital within a short period of time. Any remedial action needs to transpire within a Solvency Assessment and Management: Pillar 2- Sub Committee – Stress Testing Task Group Discussion Document 97 (v 4) – Stress testing considerations for groups

Position Paper 92 – Assessment of Group Solvency

“Choice of method

The task group proposes the following for purposes of SAM:

- *The DA method should be the default method under SAM;*
- *However, groups should be allowed to use the AC method, but requires approval by the Regulator,*
- *A combination of the D&A and AC methods, which allows for diversification between group entities included under the AC part.*

*It is furthermore proposed that allowance for diversification should only be allowed for between South African insurance participations regulated under SAM where the AC method is used, and not include group diversification benefits for insurance participations in **non-equivalent jurisdictions**. The latter implies that all insurance participations in non-equivalent jurisdictions should be included using the DA method.*

Deduction and Aggregation Method

The deduction and aggregation 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;

Group solvency equals

Eligible own funds of the parent and proportional share in related insurers;

Less the value of the parent in related insurers (to ensure no double counting)

Plus the SCR of the parent and proportional share of SCR of related insurers;

The solo SCRs need to be adjusted to avoid double charging of risks (market, default, operational and underwriting risks) for intra-group transactions. Similarly, the equity risk charge should also be removed within the solo SCR calculation for insurance participations.

The group may take into account materiality considerations for purposes of the adjustment for intra-group transactions. When calculating the aggregated group SCR the capital charge on intragroup transactions should be eliminated in order to avoid double counting risk charges. This will imply:

- *for internal reinsurance by eliminating the counterparty default charge on the internal reinsurer (as long as 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).*

After elimination for double counting intra-group transactions the adjusted solo SCR should never be lower than the MCR of the considered (re)insurance undertaking as the floor to group MCR;

Where an insurance subsidiary is in deficit (i.e. not enough eligible own funds to cover SCR), 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"

Recommendations:

1. We conclude that this paper should form part of a larger study on recovery and resolution planning. We are of the view that a Recovery and Resolution framework must include:
 - a. Qualitative and Quantitative Recovery triggers
 - b. Stress Scenarios
 - c. Identification of critical functions and critical shared services

Definition and scoping of intra-group support measures (IGSMs) (Joint Forum)

2. Intra-group support consists of various types of support measures, in particular capital and liquidity support measures, extended between entities within a group in times of stress or unexpected loss.
3. Intra-group support measures are:
 - a. legally enforceable commitments for financial assistance or assurance made by one group entity (usually a parent) upon which another group entity (usually a subsidiary) can call in times of stress or unexpected loss; or
 - b. commitments which regulators would regard as reliable means of support.
4. These measures typically increase the risk of loss to the provider when called upon by a beneficiary that subsequently fails.
5. Support measures can vary between jurisdictions due to differing
 - a. regulatory,

- b. legal or
 - c. tax regimes.
6. Support measures can stem either from
- a. contractual agreements or
 - b. as a matter of law or
 - c. regulation.
7. They can take the form of
- a. ongoing or
 - b. contingent support, secured or unsecured, within national boundaries or cross-border.
8. These intra-group support measures may exist between
- a. regulated entities or
 - b. between regulated and unregulated entities and
 - c. can take place on a cross-sectoral basis.
9. The direction of support may also vary in relation to the hierarchy of the group's legal control structure.
10. Support provided by a subsidiary to its parent is referred to as “**upstream**” support whereas support provided by a parent to its subsidiary is referred to as “**downstream**” support.
11. Differing regulations related to intra-group support measures and the varying types of contractual agreements determined by specific market practices and/or business models have resulted in a broad range of intra-group support measures across financial groups

Relevant to Insurance Groups:

Criteria for IGSM to be recognised as eligible own funds at group level during events of distress

12. The creation of an intra-group support **framework** requires an application by the parent company. Any support may not endanger compliance with capital rules, but support measures may be granted notwithstanding any limitations of domestic laws. (EU Crisis Management Directive)
13. In general, crisis management responsibilities are taken over by senior management. The crisis management team at group level usually involves the CFO, the CRO and senior company representatives (from affected business units, the risk management department, Treasury, the legal department etc.). This team is supposed to first make proposals to the board of management (Board of the Insurer / Insurance Group) and after formal approval to execute the contingency plan. (Geneva Association)
14. As part of intra-group financial support, a group financial support agreement is considered as a governance measure for intra-group support. The group financial support agreement should be reviewed by the supervisor. (Ref document: DG Internal Market & Services)
15. Group financial support (IGSMs) should only be provided under a group support agreement if a number of conditions are met and are included in the agreement. These

conditions include the following:-

- a. There is a reasonable prospect that the support provided will redress the financial difficulties of the entity receiving the support;
- b. The provision of the financial support has the objective of preserving or restoring the financial stability of the group as a whole;
- c. The financial support, if desired, is provided for consideration to the entity providing the support by the entity that receives it is in accordance with the terms of the agreement;
- d. The financial support may only be provided if, on the basis of the information available to the management body (Board of the Insurer / Insurance Group) at the time when the decision to grant financial support is taken, it is reasonably certain that the measure will be reimbursed or the consideration for the support will be paid by the entity receiving the support. ;
- e. The financial support may only be granted if it does not jeopardize the liquidity or solvency of the entity providing the support. (Ref document: DG Internal Market & Services)

16. The quality of risk measurement and management, along with other non-quantifiable elements such as the quality of governance in an undertaking or group, and the strength of its internal controls, are critical to avoiding insurance failures and near-misses.(FSA Discussion Paper)

Specific types of intra-group support measures to be considered allowable under a severe stress-event (Joint Forum)

17. The following list provides an overview of the different intra-group support measures.

18. It should again be noted that a number of these measures, although used for business as usual purposes, are also available for and could be used in periods of stress:

- a. Committed facilities (senior loans)
- b. Subordinated loans
- c. Letter of credit
- d. Guarantee
- e. Equity injection
- f. Bond swaps
- g. Bond lending / repo agreement
- h. Letter of comfort / Declaration of backing

19. Each item must be clearly explained in the application process in terms of its features and rules. The above is not necessarily a complete list.

Relevant to the Insurance Regulator:

General Comments and Notes to consider as part of designing the regulatory framework for intra-group support measures:

20. The supervisor requires the insurer's enterprise risk management framework to provide for the identification and quantification of risk under a **sufficiently wide range of outcomes** using techniques which are appropriate to the nature, scale and complexity of the risks the insurer bears and adequate for risk and capital management and for solvency purposes. (ICP 16.1)

21. The ERM of an insurance group should address the direct and indirect interrelationships between its members. The more clearly-defined and understood such relationships are, the more accurately they can be allowed for in the group-wide solvency assessment. For example, legally enforceable capital and risk transfer instruments (CTRI) established between insurance group members may help to establish the integrity of the insurance group and the effectiveness of its ERM framework for group-wide solvency assessment purposes. (ICP 16.1.21)
22. The supervisor requires:
 - a. The insurer, as part of its ORSA, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements;
 - b. The insurer's continuity analysis to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements. (ICP 16.15)
23. The ORSA process must create stress test scenarios to evaluate the depth and quality of the group's capital base and includes triggers that are monitored to evaluate the capital adequacy of the insurers and group. (Joint Forum)
24. The group must assess the transferability of own funds in stress scenarios, for solvency purposes, including the timing and the costs with which the own funds can be allocated in those scenarios. This implies the following requirements on a group
 - a. Scenario analysis on the impact of stress events on the transferability of own funds in the group.
 - b. A strategy on how the group would manage financial stress in one or several legal entities.
 - c. Contingency plans in place on how to raise and allocate capital in the event of losses that threaten the position of the group (CEIOPS)
25. When valuation methodologies differ significantly between subsidiaries and between subsidiary and parent; as for example because of different rules over cross border jurisdictions, these differences must be included in the analysis of the Insurance Group. (FSB).
26. The Insurance Group must provide governance over the process of monitoring the group's capital base. (Joint Forum)
27. The Insurance Group must maintain a Contingency Funding Plan that measures the company's liquidity profile under a base case and stress scenarios. The plan contains triggers and potential action steps. (Joint Forum)
28. Preventive and corrective plans include agreed and acceptable steps to be taken to resolve the issues raised within an acceptable timeframe. Once preventive and corrective plans have been agreed to or imposed, the supervisor periodically checks to determine that the insurer is complying with the measures. (ICP 10.4)
29. Intra-group support measures should be considered a subset of intra-group

exposures/transactions. Wider intra-group exposures/transactions relating to “business as usual” activities are not considered to be intra-group support measures. (Joint Forum)

30. Intra-group support measures can vary from institution to institution, driven by regulatory, legal and tax environments as well as the management style of the particular institution and the cross-border nature of the business. Authorities should be mindful of the complicating effect of these measures on resolution regimes and the recovery process in the event of failure. (Joint Forum)
31. **IGSMs** differ per insurer and are a crucial part of the management function and measures are mainly a choice between guarantees, loans and equity injections. {See point 18 for a more comprehensive list.} A key factor to consider is whether the groups manage capital and liquidity on a centralised basis or whether each entity manages in a self-sufficient or self-contained manner. Therefore the models used impacts the nature and design of intra-group support measures. (Joint Forum)
32. An **IGSM** can be part of normal business practices, but can also become a support measure in a financial crisis (eg the extension of a credit line). As such, intra-group exposures that are likely to become a support measure in times of stress were given consideration. (Joint Forum)
33. Insurance groups and conglomerates use internal group reinsurance, however, due to the nature of reinsurance, it was not considered a support measure for the purposes of the study conducted by the Joint Forum as it is generally called upon only when certain events specified in the contract materialise and generally not when other stressful events occur. (Joint Forum)
34. Support measures can also take place between regulated and unregulated entities. (Joint Forum)
35. The group support regime facilitates the operation of the ladder of supervisory intervention at group level. If undertakings in a group are required to hold capital to meet their SCRs separately, own funds held to meet the SCR of a subsidiary which is not suffering financial stress cannot be transferred to support another subsidiary which has experienced unexpected losses. (FSA Discussion Paper). It is recommended that own funds in excess of SCR can be transferred.
36. There are several elements which together can deliver a sufficiently forward looking approach and ensure timely intervention where there are risks to the financial condition of a subsidiary in the group support regime. These are in summary:
 - a. the requirement to report the risk of non-compliance with:
 - i. the subsidiary’s MCR
 - ii. the subsidiary’s SCR
 - b. the requirement to report the risk of non-compliance with the Group SCR
 - c. a proposal for Early-Warning Indicators at a subsidiary and group level
 - d. the power to require a recalculation of the subsidiary’s SCR (FSA Discussion Paper)
37. The Supervisor can consider the use of Early Warning Indicators for the subsidiaries of the group, paying particular attention to the information they would provide which is specific to each subsidiary. The details of what sorts of information are relevant and their relative importance will be different in each insurance group so logically they are

best left to level 3; but some of the kinds of information that might reasonably be considered are listed here:

- a. significant unexpected changes in technical provisions;
- b. material changes to risk profile through e.g. new business classes, rapidly
- c. growing business lines, a changed asset strategy or changes to the
- d. reinsurance programme;
- e. large scale changes in senior management and/or internal structure;
- f. other significant unexpected departures from the business plan;
- g. unexpected changes in pricing, expenses and profitability;
- h. outlier results when compared against peers in the local market (FSA Discussion Paper)

38. However in a group context where risk and capital management is conducted at group level but ultimately recapitalisation occurs to protect policyholders of the various subsidiaries in the group, it is logical for the group to provide supervisory authorities with an assessment of its capacity to respond to financial stress including where that leads to a breach of the group SCR. (FSA Discussion Paper)

39. When an insurer suffers significant unexpected losses other means have to be employed on a temporary basis until compliance with the SCR is restored. Those means require in any case more intensive supervision and the provision of a realistic plan to restore compliance with the SCR. (FSA Discussion Paper)

40. The Group SCR, although a key element in group supervision, is not the sole means of providing protection to policyholder access the group. The right balance must be achieved by applying the pillar one requirements on technical provisions and the MCR at the level of each undertaking, while imposing the SCR as the binding capital requirement at group level **and allowing the difference of the SCR and MCR of each subsidiary to be met by group support.** (FSA Discussion Paper)

41. The following needs to be defined in order to have an effective IGSMs framework:

- a. When should IGS-measure become effective?
- b. What is SCR?
- c. What is MCR?
- d. What is Group SCR?
- e. What is Group MCR?
- f. Will capital-add on still apply in distress situations?
- g. What about other pre-actions:
 - i. Recovery plans,
 - ii. Report additional elements to the supervisor,
 - iii. Require the firm to de-risk its asset portfolio,
 - iv. Introduce additional capital requirements,
 - v. Prohibit the free disposal of assets,
 - vi. Ban certain operations,
 - vii. Restrict new business,
 - viii. Remove senior management, and/or
- h. Transfer the powers of the board to a special commissioner

The Supervisor must consider the following in terms of intra-group support measures (IGSMs)

42. The importance and variety of intra-group support measures within financial groups has increased the supervisory challenges of ensuring that regulated entities and their

stakeholders are protected from risks arising from the use of such support measures. In general, supervisory concerns arise when intra-group support measures:

- a. result in capital, income or assets being inappropriately transferred from the regulated entity, or result in intra-group creation of capital resources (ie double or multiple gearing);
- b. are used as a substitute for financial resources (eg using a guarantee or loan rather than capital held at the subsidiary);
- c. are implemented on terms or under circumstances which third parties would not accept;
- d. adversely affect the solvency, liquidity and profitability of individual entities within a group;
- e. result in contagion risk, thereby precipitating knock-on effects on financially sound entities when one entity within the group experiences stress;
- f. complicate group structures and therefore obscure the supervisor's view of the group and/or legal entities that operate within their jurisdictions, thus affecting both the ability to supervise on an ongoing basis, and resolution and recoverability; and
- g. are used as a means of regulatory arbitrage to evade capital or other regulatory requirements altogether.

43. There are legal, regulatory and tax restrictions which could make it difficult to quickly transfer capital or liquidity from a foreign subsidiary to the parent or, more generally, from one affiliate to another. (Joint Forum)

44. The memorandum and articles of association (or equivalent) and applicable law will determine whether support can be provided. (Joint Forum)

45. Banking subsidiaries face legal lending limits on the amount of liquidity they can upstream to their parent even when they have excess liquidity. (Joint Forum)

46. As a general rule to IGMS, there might be severe legal restrictions in their ability to upstream. (Joint Forum)

47. Insurance entities face concentration limits when providing funding to affiliated banking entities. (Joint Forum)

48. Spreading limitation on insurers that are part of a group which include a bank (SA QIS 3 OF7.4) might negatively impact the financial conglomerate during a period of severe stress (DD 26)

49. Minimum capital requirements for all other insurers and the Insurance Group must be met after the agreement for IGSMs. (Joint Forum)

50. The ladder of intervention and the timing of introducing IGSMs.

Other

51. **When in severe stress scenario or failure to comply with the SCR/MCR:** An insurer should be required to submit a report to the regulator within specified time periods outlining a comprehensive financial plan that identifies the conditions that contributed to the company's financial condition. The plan must contain proposals to correct the financial problems and provide projections of the financial condition, both with and without the proposed corrections. The plan must list the key assumptions underlying

projections and identify the quality of, and the problems associated with, the insurer's business. (Joint Forum)

52. The Regulator must request that the Insurance Group and Insurer must submit frequent feedback in order for the Regulator to closely monitor the transaction and financial situation and position of the Group and Insurer.

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