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IWCFC's Recommendations to Address the Consequences of the Differences in Sectoral Rules on the Calculation of Own Funds of Financial Conglomerates – Draft for consultation

Positions of the German Insurance Association

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Summary

The German insurance industry welcomes IWCFC's draft "recommendations to address the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates". We are of the opinion that the paper takes account of the principle "same risk – same capital, different risk – different capital". The principle should in particular apply to the supervision of financial conglomerates where banking and insurance elements are combined.

We are convinced that the review of the Financial Conglomerates Directive should also be used to modernize the supervisory regime on a more fundamental basis. The timing would be ideal. The European Commission's proposal for a Solvency II Framework Directive was published in 2007. The fundamentals of the future regime are clear: full economic view and reflection of all risks. They are different from Basel II and more advanced. The review of the Financial Conglomerates Directive should take account of the fundamentals and thus introduce an economic approach

- reflecting all risks,
- allowing the use of internal models/partial models,
- acknowledging diversification effects as one of the main characteristics of financial conglomerates.

With regard to **hybrid capital**, a coherent set of principles and requirements should be implemented applying to both, banks and insurers. All work streams being currently carried out in the banking sector and in the insurance sector should be taken into consideration (Basel II and Solvency II on the one hand, the CEBS proposal and QIS4 on the other hand). A coherent consultation approach should be installed, also ensuring that the comments and concerns of both, the banking and the insurance industry, are reflected on a consistent basis.

As far as **revaluation reserves and unrealized gains** are concerned, we share IWCFC's view that there is no need for cross-sectoral harmonization. Banking and insurance business models are different in this respect.

Concerning **participations and deductions**, we doubt whether sectorally different provisions give rise to regulatory arbitrage. Financial conglomerates are (re-) structured for other reasons than that. Consequently, the rules should not be changed.

With respect to the **methods of calculation**, we share IWCFC's view that financial conglomerates should be able to calculate their capital requirements based upon the "accounting consolidation method" and the "deduction and aggregation method". Moreover, a combination of the methods should be possible.

We are also of the conviction that the **definition of financial conglomerates** should take account of the proportionality principle, i.e. with a view to financial conglomerates that do not run material risks it is sufficient to supervise the insurance and the banking group separately. But we would also welcome an opt-in clause applying to such financial conglomerates.

Introductory Remarks

The German Insurance Industry welcomes IWCFC's "Recommendations to address the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates – Draft for consultation". The paper addresses the most relevant current issues concerning the supervision of financial conglomerates. Moreover, the characteristics of the insurance business model are well taken into account. It is our conviction that banking and insurance solvency rules should be aligned when risks are the same; when risks are different, sector-specific rules should be applied. This principle is well acknowledged in the IWCFC paper.

From our viewpoint, it is additionally necessary to tackle the future issues concerning the supervision of financial conglomerates. Right now, on the basis of the review of the Financial Conglomerates Directive, there is a unique chance and an ideal timing to modernize the supervisory system on a more fundamental basis and to streamline the financial conglomerates supervisory regime as an interlinked supervisory approach: banking and insurance.

This position paper outlines the elements a future supervisory approach could be based upon and gives an overview of answers to IWCFC's specific questions.

1 The Need to Modernize the Supervision of Financial Conglomerates

The review of the Financial Conglomerates Directive (2002/87/EC) offers a unique chance to modernize the current financial conglomerates supervisory approach and to reflect the sectors' characteristics.

Holding on to the current supervisory approach applying to financial conglomerates would mean combining Basel II with Solvency II (starting 2012) and thus an accounting perspective with an economic perspective. Consequently, it would be less possible to manage and to supervise financial conglomerates on a consistent basis.

However, we are of the conviction that it is necessary and possible to create a consistent basis:

The European Commission's proposal for a Solvency II Framework Directive was published in July 2007. The Framework Directive is expected to be adopted by 2008/2009. All parties involved are committed to a distinct set of fundamentals the future provisions should be based upon. The most relevant of these building blocks are a full economic view, i.e. the application of current values, and the reflection of all risks insurers are exposed to. These fundamentals are different from the Basel II principles and are also much more advanced.

Against the background of this timetable, the review of the Financial Conglomerates Directive should take account of the Solvency II principles. It is feasible to introduce the principles for financial conglomerates supervisory purposes in advance:

1. Economic perspective: The supervision of financial conglomerates should be based upon a market (consistent) valuation.

2. Reflection of all risks: All risks financial conglomerates are exposed to should be reflected in the calculation of the solvency requirements.

3. Internal models/partial models: The solvency provisions applying to financial conglomerates should allow the use of internal models as well as the use of a standard approach. The companies should be motivated to develop and to use internal models as those internal models are characterized by the reflection of the companies' real risk situation.

The use of internal models for supervisory purposes should have to be approved by supervisors. Moreover, the use of partial models that combine the advantages of internal models (better risk assessment in relevant areas) and the standard approach (simplicity of calculation) should also be possible.

4. Diversification effects: Significant diversification effects are one of the main characteristics of financial conglomerates. However, the existing supervisory regime presumes a 100 % correlation in the risks of banks and insurers. Diversification effects should be reflected in internal models as well as in a standard approach. Ignoring diversification effects would generate a competitive disadvantage.

It is the German insurance industry's position

- to introduce a supervisory regime applying to financial conglomerates based on consistent and advanced solvency principles;
- to apply an economic perspective and to reflect all risks financial conglomerates are exposed to;
- to foster the use and the development of internal models/ partial models;
- to appreciate that risks of banks and insurers are not perfectly correlated and to take account of diversification effects.

2 Hybrid Capital

Hybrid capital is one of the most important capital instruments for financial conglomerates. It is a main capital resource, also for mutual companies that do not have direct access to capital markets.

It is a fact that the rules applying to banks and insurers are different, thus creating cross-sectoral barriers. There is a real need to align the rules and to make the financial sources available also to the insurance industry to create a level-playing field.

IWCFC recommends that the "principles and requirements for eligibility should be the same for banks and insurers. Differences between the two should not occur unless they reflect specificities of both sectors" (para. 57). We truly share this view and support this particular recommendation.

According to para. 58, IWCFC is of the opinion that short-term changes "could be modeled closely along the principles and requirements set out in the CEBS proposal." The German insurance industry is convinced that not only the CEBS proposal, but all work streams being currently carried out in the banking sector and in the insurance sector should be taken into consideration: Basel II and Solvency II concerning principles as well as the CEBS proposal and QIS 4 concerning their interpretations. The further timing should be impacted by these projects and not impact them. It is our firm view that a long-term robust solution would by far have more advantages than a short-term solution.

The current CEBS proposal interprets the Basel II principles with a particular focus on tier 1. The consultation period ended in February 2008. We note that the industry provided CEBS with comments highlighting some unresolved questions. Accordingly, the consultation period on the draft QIS 4 specifications also ended in February 2008. The insurance industry raised some important concerns with regard to the treatment of hybrid capital. As we all share the view that the principles and requirements on the treatment of hybrid capital should be aligned and a level-playing field should be created, a coherent consultation approach should be installed. A coherent approach would also ensure that the comments and concerns of both, the banking and the insurance industry, are reflected on a consistent basis.

At this particular stage, the German insurance industry wishes to highlight the following issues:

- Requirements on hybrid capital should recognize the marketability of capital instruments as they are an essential part of financial companies' risk buffers. Requirements on hybrid capital should not hamper strong capitalization of financial companies. The current turmoil of the financial markets again shows how important capital buffers are.
- Requirements on hybrid capital should not conflict with national law (such as tax law) and national practices.
- We are worried about the current requirement for a mandatory write-down feature for tier 1 hybrid capital by CEBS and CEIOPS. Write-downs do not generate new cash and do thus not have effects on liquidity. Write-down features do not contribute to the financial security and do therefore not have any merits. They would affect the costs of refinancing, especially if tax treatment equals to equity.
- Another concern are the requirements as regards ACSM (Alternative Coupon Settlement Mechanism). We are of the conviction that allowing only for conversion into equity would make such instruments uncomfortable for some investors. Other mechanisms provide similar qualities of capital instruments and should be accepted as well.
- Step-up coupons after 10 years from the issue date (not: from reporting date as in QIS4 draft specification) should be allowed for tier 1 capital. They are not a substantial incentive to redeem, but they contribute to placing hybrid capital adequately.

The German insurance industry is keen to contribute to developing sound and tailored requirements on hybrid capital.

The German insurance industry

- shares IWCFC's recommendation that the principles and requirements for eligibility should be the same for banks and insurers and differences between the two should not occur unless they reflect specificities of both sectors;
- is convinced that all work streams being currently carried out in the banking sector and in the insurance sector should be taken into consideration: Basel II and Solvency II on the one hand as well as the CEBS proposal and QIS 4 on the other hand;
- is of the opinion that a coherent consultation approach should be installed.

3 Revaluation Reserves and Unrealized Gains

IWCFC argues that the issue of revaluation reserves and unrealized gains is a valuation issue that “at the same time requires a consistent approach on the capital requirements” (para. 66). We share this view as we are of the opinion that eligible elements and capital requirements cannot be dealt with separately.

We also share IWCFC’s argumentation that sectoral specificities justify the fact that revaluation reserves and latent gains are treated in a different way. It is correct that “due to the long duration of their liabilities insurance companies are not obliged to realize certain assets immediately” (para. 67). This is why insurers typically generate a positive and steady amount of unrealized gains.

The German insurance industry shares IWCFC’s perspective that concerning revaluation reserves and unrealized gains there is no need for a cross-sectoral harmonization.

4 Participations and Deductions

It is a fact that participations are treated in a different manner in the banking sector and in the insurance sector. However, we doubt whether the different treatment gives rise to regulatory arbitrage.

In this particular context, regulatory arbitrage could occur in two particular cases:

- Should the participation be less than 10 %, but should there be a durable link, regulatory arbitrage could occur if a participation was transferred from an insurer to a bank.
- Should the participation be less than 20 %, but should there be no durable link, regulatory arbitrage could occur if a participation was transferred from a bank to an insurer.

Consequently, it would be inaccurate to conclude that the one supervisory regime is stricter than the other supervisory regime. It rather depends upon the situation.

Moreover, a financial conglomerate's organizational structure is the result of strategic decisions. It is such aspects as the conglomerates' sales strategy and human resources strategy that drive the structure. It has not been experienced so far that a financial conglomerate was restructured for regulatory arbitrage reasons in the context of participations and deductions.

The German insurance industry

- is of the opinion that the provisions should currently not be changed;
- shares IWCFC's view to gather some more information on this particular issue.

5 Methods of Calculation

We welcome the fact that the IWCFC paper does not only address the issue of eligible elements, but also the calculation of capital requirements. Eligible elements and capital requirements are two sides of the same coin that cannot be dealt with separately and that are closely interlinked.

We share IWCFC's perspective that financial conglomerates should be allowed to use both, the "accounting consolidation method" and the "deduction and aggregation method", to calculate the capital requirements. The use of these two methods is in line with the current proposal for a Solvency II Framework Directive.

According to para. 104, supervisors should have the discretion "to require companies to use the deduction and aggregation method for some or all of the conglomerate group". It is of utmost importance that this statement refers to the possibility to carry out a calculation based upon a combination of the "accounting consolidation method" and the "deduction and aggregation method". For example, companies that are legally separate entities, but under unified control without a parent company ("Gleichordnungskonzern") have to be able to use a combination of the two methods. Those companies do not set up consolidated accounts for the whole group which could be the starting point to calculate the group solvency based upon the consolidated method. Those companies set up consolidated accounts for each entity separately and thus conduct the "accounting consolidation method" for each entity separately. Concerning the entire group ("unified control") however, the use of the "deduction and aggregation method" on top of those separate calculations ensures that a group solvency assessment can be carried out. A combination of the two methods is also in line with Solvency II.

IWCFC uses the example of a lack of integration. From our perspective, the example is fine. Another example is the companies' organizational structure (see the reasons given above). The second example should also be listed in the text.

It is the German insurance industry's position

- that financial conglomerates should be able to calculate their capital requirements based upon the "accounting consolidation method" and the "deduction and aggregation method";
- that financial conglomerates should also be able to use a combination of the "accounting consolidation method" and the "deduction and aggregation method".

6 Definition of Financial Conglomerates

We are convinced that the Financial Conglomerates Directive should reflect the proportionality principle. The Directive should not apply to companies that carry out insurance business and banking business (e.g., a building society), but

- do not run material risks and
- do not have an impact on the stability of the financial markets.

For such financial conglomerates, the separate supervision of the insurance and banking group is sufficient. A threshold separating companies with a significant impact on the financial markets from companies without a significant impact could be a balance sheet total of, say, EUR 10 billion. We propose to introduce a company option applying to financial conglomerates below the threshold: They should have the opportunity to decide themselves if they want to be subject to the financial conglomerates supervisory regime (opt-in clause). If those financial conglomerates vote for an opt-in, a participation in another financial company has to be taken account of at top level. If they do not vote for an opt-in, a participation has to be account of at solo level.

The German insurance industry is convinced

- that the financial conglomerates supervisory regime should reflect the proportionality principle, i.e., the Financial Conglomerates Directive should not apply to financial conglomerates not running material risks and not affecting the stability of financial markets;
- that – reflecting the proportionality principle – an opt-in clause applying to companies whose balance sheet total is less than EUR 10 billion should be introduced.

7 Further Proposals Concerning the Review of the Financial Conglomerates Directive

In addition to the proposals made so far, we suggest to amend the Financial Conglomerates Directive as follows:

- The Financial Conglomerates Directive needs to catch up with the Reinsurance Directive which has come into force in the meantime. Reinsurance undertakings must be recognized as “regulated entities” since they are subject to supervision. We thus propose to amend the Financial Conglomerates Directive as follows:

> “Article 2
> Definitions
> For the purposes of this Directive: …
> 4. "regulated entity" shall mean a credit institution, an insurance undertaking, a reinsurance undertaking or an investment firm; …
> 6. "reinsurance undertaking" shall mean a reinsurance undertaking within the meaning of Article 12 (1) (c) of Directive ~~98/78~~2005/68/EC;”

- The Financial Conglomerates Directive already provides for sufficient supervisory measures with regard to risk concentrations. They are subject to constant supervision and may be limited by the supervisor, where necessary on a case by case basis. A strict quantitative limit for risk concentrations which applies generally is no longer prudent given the development of risk management since the Financial Conglomerates Directive has come into force. Such a development has been fostered e.g. by the CRD and the FCD itself. This is why we propose to amend the Financial Conglomerates Directive as follows:

> “Article 7
> Risk concentration
> 1. Without prejudice to the sectoral rules, supplementary supervision of the risk concentration of regulated entities in a financial conglomerate shall be exercised in accordance with the rules laid down in Article 9(2) to (4), in Section 3 of this Chapter and in Annex II.
> 2. The Member States shall require regulated entities or mixed financial holding companies to report on a regular basis and at least annually to the coordinator any significant risk concentration at the level of the financial conglomerate, in accordance with the rules laid down in this Article and in

Annex II. The necessary information shall be submitted to the coordinator by the regulated entity within the meaning of Article 1 which is at the head of the financial conglomerate or, where the financial conglomerate is not headed by a regulated entity within the meaning of Article 1, by the mixed financial holding company or by the regulated entity in the financial conglomerate identified by the coordinator after consultation with the other relevant competent authorities and with the financial conglomerate.
These risk concentrations shall be subject to supervisory overview by the coordinator in accordance with Section 3.
~~3. Pending further coordination of Community legislation, Member States may set quantitative limits or allow their competent authorities to set quantitative limits, or take other supervisory measures which would achieve the objectives of supplementary supervision, with regard to any risk concentration at the level of a financial conglomerate.~~
4. Where a financial conglomerate is headed by a mixed financial holding company, the sectoral rules regarding risk concentration of the most important financial sector in the financial conglomerate, if any, shall apply to that sector as a whole, including the mixed financial holding company.

Article 8
Intra-group transactions
1. Without prejudice to the sectoral rules, supplementary supervision of intra-group transactions of regulated entities in a financial conglomerate shall be exercised in accordance with the rules laid down in Article 9(2) to (4), in Section 3 of this Chapter, and in Annex II.
2. The Member States shall require regulated entities or mixed financial holding companies to report, on a regular basis and at least annually, to the coordinator all significant intra-group transactions of regulated entities within a financial conglomerate, in accordance with the rules laid down in this Article and in Annex II. Insofar as no definition of the thresholds referred to in the last sentence of the first paragraph of Annex II has been drawn up, an intra-group transaction shall be presumed to be significant if its amount exceeds at least 5 % of the total amount of capital adequacy requirements at the level of a financial conglomerate.
The necessary information shall be submitted to the coordinator by the regulated entity within the meaning of Article 1 which is at the head of the financial conglomerate or, where the financial conglomerate is not headed by a regulated entity within the meaning of Article 1, by the mixed financial holding company or by the regulated entity in the financial conglomerate identified by the coordinator after consultation with the other relevant competent authorities and with the financial conglomerate.

These intra-group transactions shall be subject to supervisory overview by the coordinator.

~~3. Pending further coordination of Community legislation, Member States may set quantitative limits and qualitative requirements or allow their competent authorities to set quantitative limits and qualitative requirements, or take other supervisory measures that would achieve the objectives of supplementary supervision, with regard to intra-group transactions of regulated entities within a financial conglomerate.~~

4. Where a financial conglomerate is headed by a mixed financial holding company, the sectoral rules regarding intra-group transactions of the most important financial sector in the financial conglomerate shall apply to that sector as a whole, including the mixed financial holding company."