Comparison of the sectoral rules for the eligibility of capital instruments into regulatory capital

I. Introduction

Background

1. As part of their cross-sectoral work, CEBS and CEIOPS have undertaken a comparison of the capital instruments that are eligible within European banking, insurance and securities regulation for prudential purposes.

2. This cross-sectoral comparison has been produced by the Interim Working Committee on Financial Conglomerates ('IWCFC'), which was mandated to undertake work in this area by the European Financial Conglomerates Committee ('EFCC') at its March 2006 meeting. This report contributes to part (a) of the Call for Technical Advice agreed by the EFCC in this area.

3. This comparison aims to identify the similarities and differences between the capital instruments currently eligible within European banking, securities and insurance regulation.

4. It is believed that this work will complement the surveys already carried out and published by both CEBS and CEIOPS, in the context of the European Commission's Calls for advice on the definition of own funds:

   a. CEBS’ surveys of national implementation of the current own funds rules across the EU\(^1\) [http://www.c-ebs.org/Advice/OF_part1_rules.pdf](http://www.c-ebs.org/Advice/OF_part1_rules.pdf) and of capital instruments recently created by the industry [http://www.c-ebs.org/Advice/OF_part1.pdf](http://www.c-ebs.org/Advice/OF_part1.pdf). These two surveys were undertaken in response to the European Commission's call for advice on own funds [http://www.c-ebs.org/Advice/OF_mandate.pdf](http://www.c-ebs.org/Advice/OF_mandate.pdf);

\(^1\) Hereafter referred to as 'CEBS report'.
b. CEIOPS’ answers to the Calls for advice of the European Commission in the context of the Solvency II project, in particular Call for advice 19, available at: http://www.ceiops.org/content/view/14/18/; and

c. CEIOPS’ advice with regard to the “Treatment of deeply subordinated debt”, available at: http://www.ceiops.org/content/view/14/18/#CP12

d. CEIOP has issued a further Consultation paper on further Pillar I standards (CP 20).  

Methodology

5. The comparison has been carried out on the basis of the current sectoral Directives and the Financial Conglomerates Directive 2002/87/EC, to the extent that it impacts on the sectoral Directives. For the banking sector, these are Directives 2006/48/EC and 2006/49/EC. These Directives cover both credit institutions and investment firms. The differences, if any, between the rules applicable to investment firms and those applicable to credit institutions have been highlighted in the report; otherwise references to the banking sector include investment firms. For the insurance sector, the relevant Directives are the Recast Life Directive 2002/83/EC, the First Council Directive on the taking-up and pursuit of the business of direct insurance other than life assurance 73/239/EEC, as amended, and the Directive on supplementary supervision of insurance undertakings in an insurance group 1998/78/EC.

6. Moreover, it must be noted the context of the upcoming risk-sensitive new regime of Solvency II which will impact significantly a lot of current rules.

7. In the banking sector, the Banking Directives have been recently modified to transpose the risk-sensitive Basel II framework in the EU legislation.

8. The comparison includes the limits that are applicable to the inclusion of particular capital instruments, as well as deductions from capital elements.

9. In recent years, banking supervisors and insurance supervisors have been asked to consider, for regulatory own funds purposes, capital instruments that have similar characteristics to, but do not have the same quality as, core original own funds. These capital instruments are usually called ‘hybrids’ as they combine to some extent features of both debt and equity.

10. Therefore, although hybrid instruments or hybrid features of instruments are not addressed or not properly taken into account by

---

2 http://www.ceiops.org/content/view/14/18/#
the sectoral Directives\(^3\), it has been deemed relevant, given the 
increasing importance of this market, to identify the similarities and 
differences in the nature of the instruments and in the extent to 
which hybrids are given regulatory treatments.

11. The cross-sectoral comparison looks at both the solo calculation and 
the consolidated calculation of regulatory capital, thereby addressing 
for instance the treatment of participations and minority interests and 
IAS/IFRS developments.

12. In the insurance sector, under Solvency I, there is no definition of 
‘regulatory group’ and no ‘supervision on a consolidated basis’ like in 
the banking sector. However, for ease of reference, the report (and 
specially Chapter 6) uses the term ‘group capital adequacy’ or ‘group’ 
to refer to ‘adjusted solvency requirement’ and ‘entities included in 
the calculation of the adjusted solvency requirement’ as defined in 
the Insurance Group Directive.

13. CEIOPS’ CP 20 and answer to the Call for advice 10 on subgroup 
supervision in the context of Solvency II should be also taken into 
consideration.

14. With regard to IAS/IFRS, since 1 January 2005 European listed 
companies have had to publish, as a minimum, consolidated financial 
statements based on the new International Financial Reporting 
Standards (IFRS) rules. The IFRS accounting developments may 
affect the magnitude, the quality and volatility of institutions’ 
available regulatory capital. As accounting numbers remain the basis 
for the computation of prudential/regulatory ratios, prudential filters 
have been developed and used for both sectors.

15. In this context, the comparison of eligible capital elements has 
benefited from CEIOPS’ Recommendation regarding the implications of 
the IAS/IFRS available at http://www.ceiops.org/content/view/14/18/#, CEBS’ analysis of the 
impact of IAS/IFRS on institutions’ regulatory capital and main 

16. The report aims to describe factually the elements eligible in both 
sectors but does not provide any recommendations on whether or 
how the elements should be eligible.

17. The scope of the exercise is not to carry out a thorough analysis of 
the differences of the banking and insurance businesses. CEBS survey 
on the implementation of own funds rules across the EU and the

\(^3\) The Banking Directive, Article 61 states that the concept of own funds as defined in points 
a) to h) of Article 57 embodies a maximum number of items and amounts. The use of those 
items and the fixing of lower ceilings, and the deduction of items other than those listed in 
points i) to r) of Article 57 shall be left to the discretion of the Member States. In the 
states a number of items and amounts the solvency margin can also consist of, under certain 
criteria and within limits (see par. 166).
outcome of the CEIOPS questionnaire on regulatory capital of insurance entities across the EU will contribute to have a better understanding on the practices in the banking and insurance sectors.

18. The impact of Solvency II and CEIOPS’ and CEBS’ answers to the European Commission’s call for Advice are mentioned where applicable.

19. The report begins with the analysis of similarities and differences of the capital items common to both sectors, set out separately for those items with and without limits.

20. The report also highlights elements which are specific to each of the sectors.

21. Later, special attention is given to the ways regulatory capital is calculated:

   a. comparing the various limits that are applicable to the inclusion of particular capital instruments;

   b. comparing the elements that are deducted from regulatory capital; and

   c. indicating the impact of the methods of consolidation and the impact of IAS/IFRS, with a special focus on the comparison of prudential filters.

Terminology


23. The Banking Directives are in some cases drafted in more details than the Insurance Directives, with the consequences that although rules are worded differently, they do not reflect significant differences in substance.

24. With regard to the banking sector, the report maintains the terminology used by the Banking Directives to qualify the layers of own funds, i.e. “original, additional, ancillary own funds”, while keeping in mind that market participants usually refer to ‘tiers’ of regulatory own funds.


26. However, in its answer to Call for advice 19 and in CP 20, CEIOPS suggests categorising the eligible elements of capital into three tiers, namely Tier 1 capital, which is recognized without limits, Tier 2 capital and insurance Tier 3 capital, which are limited. Additionally, insurance Tier 3 capital is subject to prior approval by the supervisory authority since it comprises unpaid elements. Tier 1 capital as it is described in the answer to Call for advice 19 is comparable to the capital items with unlimited recognition under the current Directives and equates closely to "original own funds" in the banking sector. Therefore, in addition to being "free of any foreseeable liabilities", it has to be "(...) fully loss absorbent and therefore needs to be currently and permanently available." (see para. 19.49 of CEIOPS answer to Call for advice 19). Tier 2 equates to "additional own funds" in the banking sector. However insurance Tier 3 capital (essentially unpaid items) does not equate to banking "ancillary own funds".

27. The Solvency II framework foresees two capital requirements, the solvency capital requirement (SCR) and the minimum capital requirement (MCR)\(^4\).

28. The SCR reflects a level of capital that enables an insurer to absorb significant unforeseen losses over a specified time horizon and gives reasonable assurance to policyholders that payments will be made as they fall due. The parameters should be calibrated in such a way that the required level of capital corresponds to a ruin probability of 0.5% (working hypothesis) at a one year time horizon.

29. The MCR reflects a level of capital below which ultimate supervisory action would be triggered. It should be calculated in a more simple and robust manner than the SCR as this kind of action may need authorisation by national court. It will have an absolute floor.

30. Under Solvency II it is likely that assets free of unforeseeable liabilities which are admitted to cover capital requirements will be subject to certain investment limitations. This would give rise to a difference with the current banking and insurance regimes, where the quality of capital elements provides no constraints on how funds are invested once they have been obtained.

31. In the banking sector capital requirements are calculated on the basis of the risks posed by the assets of the institutions. Directives 2006/48/EC and 2006/49/EC which transpose the international Basel II accord into EU legislation introduce different approaches to the measurement of risks (and the corresponding level of capital): the standardised and the internal ratings-based approaches for credit and

market risks, and the basic, standardised and advanced approaches for operational risk.

32. Furthermore, capital instruments have recently been issued by institutions and insurance entities to raise funds in a cost-efficient and less dilutive way. These instruments are not defined under or are not adequately captured under the current Directives. Various terms are used to refer to these instruments.

33. In the banking sector the CEBS’ survey on recently created capital instruments pointed out that the industry and international rating agencies commonly refer to ‘hybrids’, as they combine to some extent features of both debt and equity. They cover a variety of instruments that are designed to be included in eligible regulatory original own funds. Preferred shares are often but not always included in this definition by virtue of their similarities with other preferred securities. The term ‘innovative’ is also used, by reference to the wording of the Sydney press release of 27 October 1998. However, ‘innovative’ is generally restricted to a specific type of hybrid instruments - those eligible for original own funds and including an incentive to redeem, e.g. step-up. By contrast, ‘non-innovative’ means that the instrument does not bear any incentive to redeem.

34. For the insurance sector, CEIOPS acknowledges the use of the terms “hybrid” and “innovative” capital. Like in the banking sector, hybrid capital is generally understood as a capital instrument that has features of both equity and debt. Like in the banking sector, it covers a variety of instruments. On the one hand, these elements are considered to have features which prevent them from being accepted as pure equity (and therefore without any limits), on the other hand they provide better loss absorption than subordinated elements with limited recognition described in the current Insurance Directives. As they are recognised under the same limits as ‘ordinary’ subordinated undated instruments in the insurance sector, their ‘hybrid’ characteristics might be regarded as not adequately reflected in the existing Solvency I. The definition is not exempt from a certain ‘vagueness’.

35. An example for hybrid capital elements formally captured under the current Insurance Directives are securities with no specified maturity date as described in Article 27(3)(b) of Directive 2002/83/EC and 16(3)(b) of Directive 73/239/EEC as amended. Examples for innovative capital forms or instruments that could be considered not to be adequately reflected in the current system are the instruments referred to in the Sydney press release and in CEIOPS CP 12 on deeply subordinated debt.

---

5 Hereafter called the Sydney Press Release, available at www.bis.org/press/p981027.htm
II. Executive summary

36. The report aims at identifying the similarities and differences between capital instruments currently eligible in the European banking and insurance regulations. The report does not address in detail national implementations of European directives. With regard to the banking sector, this was already carried out by CEBS (see http://www.c-ebs.org/Advice/OF_part1_rules.pdf) and is currently under way at CEIOPS http://www.ceiops.org/media/files/consultations/CEIOPS-SEC-74-06QuestionnaireEligibleElemCap.pdf.

37. The report equally does not attempt to set out the model answer to regulatory capital in the banking and insurance sectors going forward – it is purely intended to be a factual comparison.

38. Eligible capital elements share a lot of core commonalities:

   a. Insurance and bank entities’ regulatory capital fulfils the same overarching goal: to absorb the losses incurred by the risks of their operations, in an on-going concern basis and in situation of winding up.

   b. In the two sectors, the eligibility of capital elements depends on the extent to which the characteristics of the capital elements fulfil criteria to be counted as such buffer to losses. These criteria are permanence, loss absorption on an going concern basis and in a winding up situation, and flexibility of payments.

   c. In the two sectors, depending on their quality, capital elements have been categorised, conditions for eligibility have been set out and specific limits systems have been established in the Directives.

   d. A lot of eligible instruments are common in the two sectors but their terminology is different.

      1. For instance, capital and reserves, which are of the optimal quality and not limited in the two sectors are labelled ‘core original own funds’ (or core Tier 1) in the banking sector but called ‘capital elements eligible without limits’ in the insurance sector.

      2. Likewise, permanent or dated subordinated debts, which are subject to similar if not identical eligibility conditions are labelled ‘Additional own funds’ in the banking sector but ‘capital elements eligible with limits’ in the insurance sector.

   e. The purpose of limits to the inclusion of capital elements is to maintain a minimum level of quality of the regulatory capital. The levels and the calculation of the limits may differ, but the purpose is the same.
f. Both sectors have designed prudential filters to prevent that the introduction of the IAS/IFRS accounting regimes weakens the quality of regulatory capital. Some of them (e.g. prudential filter on equity) are similar.

39. Two types of differences in the assessment of eligibility of capital emerge from the comparison:

40. The first reflects differences in the nature of the type of business of each sector. For example,

a. unrealised profits and revaluation reserves are to a greater extent taken into account in the insurance sector. This can be explained by the different nature of the insurance business, the way the risks are managed and the fact that, in order to meet their obligations to policy holders, insurance entities tend to hold also liquid assets.

b. There are some capital elements which are truly specific to each sector and reflect the intrinsic nature of the business activities, such as profit reserves for life insurers, members' calls for mutual non-life insurers or short term subordinated loan capital for banks.

41. The second type of differences is unrelated to the differences between banking and insurance business. These may lead to regulatory arbitrage between the two sectors. For example:

a. The methods of calculation of capital differ at group level. The Directive in the banking sector uses a consolidation method while the Insurance Directive envisages three methods. One of these three methods is based on consolidated accounts. It is at large similar to the banking method and is also chosen by a majority of insurance authorities.

b. Due to specific provisions, the calculation of capital elements at consolidated level may differ, for instance minorities in consolidated capital may be limited to the minority’s share of capital requirements in the insurance sector.

c. While intra-sector deductions have the same objective of preventing double or multiple gearing in both sectors, the threshold set in the banking sector of 10% or more is significantly more onerous than the 20% threshold set for the insurance sector. Although, if the 20% threshold is not met, it might still be the case that a participation may be deducted since it is material for other reasons.

---

6 As indicated in the ‘methodology’ section above, the aim of the exercise was not to carry out a thorough analysis of the differences between banking and insurance businesses. CEBS survey on the implementation of own funds rules across the EU and the outcome of the CEIOPS questionnaire on regulatory capital of insurance entities across the EU will contribute to have a better understanding on the practices in the banking and insurance sectors.

7 E.g. accounting differences in both sectors, historical circumstances of issuance of the respective rules.

8 As explained in the definition set out in Article 17 Directive 78/660.
d. The deductions are made from different reference points: original own funds (Tier 1)/Additional own funds (Tier 2) in the banking sector, versus total of own funds in the insurance sector.9

e. The differences in the definition or application of the prudential filters (e.g. prudential filters on unrealised gains and losses) are due to the fact that the filters are defined on the basis of current prudential regulations which are different between the two sectors and within each sector.

42. Finally, in absence of an EU-wide legislation, there are different approaches to and treatments of hybrids. In the banking sector, Member States have based their assessment on the international agreement embodied in the Sydney press release (or on qualitative requirements that are very similar or complementary to that agreement). In the insurance sector, besides the limited recognition provided by the current Insurance Directives and subject to national discretion, such instruments may be allowed to cover the capital requirement that some Member States impose in addition to the capital requirement required by the Insurance Directives. Some Member States that require additional capital requirements apply the banking sector principles to the insurance sector.

43. In the process of the finalisation of this report, CEBS and CEIOPS have sought the early views of their respective Consultative Panels, on the main differences between the banking and insurance sector from a market participant’s perspective. These relate to the treatment of hybrids, the inconsistent approaches to deductions, the treatment of unrealised profits and revaluation reserves and consolidation approaches and methods.

---

9 Article 154(4) allows Member States to keep the current calculation i.e. deduction from total own funds until end 2012, for entities acquired before 20 July 2006.
# Table of content

## Chapter 1. Elements eligible without limits which are common to both sectors

1. Paid-up Capital
   1.1. Description of the characteristics of paid-up capital the banking and insurance sectors
   1.2. Both sectors consider capital subscribed and paid-up by shareholders of the entity, eligible without limit. The treatment of unpaid capital elements is the main difference between the two sectors.
2. (Statutory) Reserves
   2.1. Description of the characteristics of the (statutory) reserves in the banking and insurance sectors
   2.2. The notion of reserves is similar in the insurance and the banking sectors. Differences in the types and denominations of legal and statutory reserves arise as the result of different national company laws.
3. Profit and loss
   3.1. Description of the characteristics of items related to 'profit and loss' in the banking and insurance sectors
   3.2. The treatment of profits and losses as eligible capital is very similar in the banking and the insurance sectors.
4. Reserves for Unrealised Profits and Hidden Reserves
   4.1. Description of the characteristics of the reserves for unrealised profits and hidden reserves in the banking and insurance sectors
   4.2. Both sectors include unrealised gains and losses in eligible capital, but the extent to which they are included is different.

## Chapter 2. Elements eligible with limits which are common to both sectors

1. Hybrids
   1.1 Description of the characteristics of hybrids in the banking and insurance sectors
   1.2. Hybrids are not consistently treated across the two sectors.
2. Instruments eligible in both sectors which are subject to conditions and limits
   2.1. In the two sectors, instruments must fulfil conditions as set out in the Directives to be considered as eligible
   2.2. Securities of indeterminate duration/perpetuals with loss-absorption capacity and non-fixed term cumulative preference shares meet similar (if not identical) eligibility criteria.
   2.3. Subordinated loan capital and fixed-term cumulative preference shares must meet requirements which are broadly similar in the two sectors.

## Chapter 3. Eligible elements specific to the insurance and banking sectors

1. Few elements are intrinsically related to insurance activities-Some of them are to disappear in the new regime of Solvency II
   1.1. The elements specific to life insurers are profit reserves, zillmerising amounts and future profits.
1.2. Members’ calls are specific to non–life insurers, Article 16 4. (b) of Directive 73/239/EEC, as amended .................................................................43

2. Equally, there are few elements specific to credit institutions and investment firms ........................................................................................................44

2.1. Some specific items are related to the Capital Requirements Directive and concern Internal Ratings Based institutions .........................................................................44

2.2. ‘General provisions’, ancillary own funds and the deductions related to securitisation transactions are also specific to credit institutions and investment firms .................................................44

Chapter 4. Limits ...........................................................................................................47

1. Limits applicable in the banking sector .....................................................................47

1.1. Hybrid instruments are part of original own funds but subject to limits set by national supervisors ..........................................................................................................................47

1.2. Additional own funds are subject to the two limits laid down in Article 66 of Directive 2006/48/EC ..........................................................................................................................48

1.3. Limitations set out in Directive 2006/49/EC for ancillary own funds are very complex 48

2. Limits applicable in the insurance sector ....................................................................49

2.1. Limits applicable to capital eligible without prior supervisory approval .................51

2.2. Limits of capital admitted with prior supervisory approval ...........................................51

3. Although the limits are based on different reference points and on different level, they are tantamount to the same ....................................................52

Chapter 5. Deductions .................................................................................................53

1. Both sectors ensure that the real value of capital items is adequately stated .................................................................................................................................53

1.1. Own shares and intangible assets are deducted in the two sectors .........................53

1.2. Value deductions are deducted from different reference points ................................54

2. The deductions of holdings/participations within the same sector follow the respective sectoral rules .........................................................................................................................54

2.1. Banks deduct ‘holdings’ in credit and financial institutions and insurance undertakings, deduct ‘participations’ in insurance, reinsurance and insurance holding companies .......... 54

2.2. The threshold for deductions is more restrictive in the banking sector than in the insurance sector .................................................................................................55

3. Holdings/participations across sectors follow the rules introduced by amendment to the Banking and Insurance Directives by the Financial Conglomerates Directive .................................................................56

3.1. The Financial Conglomerates Directive extended the sectoral rules to avoid a cross-sectoral double counting effect .........................................................................................56

3.2. The differences in thresholds for deductions may lead to regulatory arbitrage .......... 58

4. Few types of deductions are specific to each sector .................................................59

Chapter 6. Prudential consolidation and consolidated capital elements in the two sectors ..........61

1. The scope of a banking group and an insurance group defined for regulatory purposes follow different rules .................................................................61

1.1. The definition of a ‘group’ for regulatory purposes ........................................................................61

1.2. Both sectors require inclusion of financial or insurance holding companies, but the methodologies differ in practice .................................................................65
1.3. In both sectors, the definition of group for regulatory purposes differs from that used for the purposes of statutory accounts ................................................................. 65
1.4. The treatment of Special Purpose Vehicles is similar in both sectors but different to most accounting standards .................................................................................. 67

2. The calculation methods differ ........................................................................ 68
2.1. While the “consolidated financial situation” of a banking group is in general obtained from consolidated statutory accounts, the ‘consolidated situation’ of an insurance group can be obtained using three different methodologies ........................................ 68
2.2. Both sectors have rules for treating intra-group capital allocation ................... 69

3. The calculation of eligible capital items may be affected by the prudential consolidation .................................................................................. 70
3.1. Double counting and intra-group creation of capital are prevented ................... 70
3.2. The composition of Consolidated Reserves is similar ...................................... 71
3.3. The treatments of hybrids follow the consolidation procedures ...................... 73
3.4. Whereas the treatment of minorities is strictly defined in the Banking Directives, the Insurance Directives leave room for different treatments ...................................................... 73

Chapter 7. IAS/IFRS implications – the use of prudential filters in the two sectors .......... 75

1. Filters apply to elements eligible without limits in both sectors .......... 75
   1.1. Both CEBS and CEIOPS have recommended similar filters on equity, (Statutory) reserves and profit .................................................................................. 75
   1.2. With regard to the following items, filters apply in the two sectors differently .............................................................. 76
   1.3. Filters specific to insurance groups have been developed ................................ 78
2. There are no specific filters relating to elements eligible with limits .79
3. Filters relating to intangible assets .................................................................. 79
4. Filters have been developed to address the sectoral specifics of banking and insurance activities .............................................................. 79

Annex: mapping table
Chapter 1. Elements eligible without limits which are common to both sectors

44. Elements eligible without limit represent – from a supervisory point of view – capital elements of the highest quality. They are key elements of institutions’ eligible capital and they are the basis on which both supervisors’ assessment and markets’ judgements of capital adequacy and financial soundness are made.

45. A main characteristic is their ability to absorb losses on a going concern basis and under stress. These elements have some capacity to prevent financial difficulties in the first place instead of just protecting depositors in the case of the institutions and policyholders in the case of insurance entities when difficulties have already occurred (which would be a function of elements eligible with limits).

46. Elements eligible without limit are usually shown as equity in the balance sheet. In rare cases, such elements are shown as liabilities.

47. As with all capital elements, the amount of loss absorbent capital is only an indication of whether an entity has a solid financial structure.

48. In the banking sector, three items are eligible without regulatory limits: capital, reserves, and funds for general banking risks\(^\text{10}\). To calculate the original own funds, own shares (at book value) held by the credit institution, intangible assets and material losses for the current financial year shall be deducted (see below) under Article 66.

49. In the insurance sector, elements eligible without limits are paid-up capital and initial or foundation fund, reserves free of foreseeable liabilities, profits and losses brought forward, profit reserves and hidden net reserves arising out of the valuation of assets provided that they are recognised by the supervisory authority. According to Directives 73/239/EEC as amended and Directive 2002/83/EC, intangible assets and own shares directly held by the insurance undertaking have to be deducted.

50. Article 61, second paragraph, of Directive 2006/48/EC sets out that these eligible items shall be available to an institution for unrestricted and immediate use to cover risks or losses as soon as they occur. In the insurance sector, there is no similar wording but Article 16.2 and 27.2 of non-life and life Insurance Directives bears the same consequences in practice.

51. In that respect, as pointed out by the CEBS report, European supervisors consider that in order to be eligible such elements must (i) be issued and fully paid-up, (ii) be permanent, (iii) be available to absorb losses on a going-concern basis and under stress, and (iv)

\(^{10}\) Only for non-IFRS institutions.
provide the institution with full discretion as to the amount and timing of distributions. Such characteristics can take various forms depending on the national accounting and corporate legal setting. In CEIOPS CP 20, the same principles are stated.

52. Elements within capital which are eligible without limits, and which exist in both sectors, are paid-up capital, (statutory) reserves and profits and losses. They are addressed in detail below.

53. This chapter also addresses the treatment of Reserves for Unrealised Profits and Hidden Reserves.

1. Paid-up Capital

1.1. Description of the characteristics of paid-up capital the banking and insurance sectors

Banking

Item (a) of Article 57 of Directive 2006/48/EC – Capital within the definition of Article 22 of Directive 86/635/EEC and share premium accounts, excluding cumulative preferential shares

54. As indicated in Directive 86/635/EEC (‘Bank Accounts Directive’), all amounts, regardless of their actual designations, which in accordance with the corporate structure are considered under national law as equity capital subscribed by the shareholders or other proprietors: the debt/equity boundary under national (corporate and accounting) law is the key element in the definition. While Section 3 of Directive 86/635/EEC includes called-up capital, Article 57(a) of Directive 2006/48/EC limits capital to amounts actually paid up.

55. Depending on the national corporate legal framework, paid-up capital can take various forms such as ordinary or non cumulative preference shares of registered commercial companies, limited liability companies or stock corporations.

56. As indicated in the CEBS report, the situation varies across Member States as company law in each Member State determines the legal form of its business undertakings, the various types of capital and therefore the ways that direct ownership and voting rights are established. For instance, in some Member States, paid-up capital elements such as preferential shares need not provide voting rights.

57. Moreover, paid-up capital can also include the funds of the general or limited partners of a partnership, and the capital of silent partners in accordance with the national legal frameworks of some Member States. In some Member States, the partners’ capital may be dated or callable. Other forms of paid-up capital include certain callable

11 These items are subject to limits defined by the relevant Member State.
preferential shares and, in some Member States, the callable capital of some cooperative societies.

58. Although the Directive does not explicitly require paid up capital to be permanent, the CEBS report showed that many Member States require at least some degree of permanence for such capital to be eligible.

59. Whereas the definition of equity under the current IAS 32.11 incorporates some capital maintenance aspects (pay-out obligations usually lead to a liability), the stricter debt/equity boundary under IAS 32 would be reversed by the prudential filter to accept capital shown as liabilities as eligible own funds (see Chapter 7 below). In any case, permanence of paid-up capital is required if the entity is covered by the capital maintenance requirements in Article 15 of Directive 77/91/EEC.

60. Share premiums are not defined and may cover additional paid up funds obtained during the issue of shares and ex-post equity financing or certain reorganisation gains from shareholders. There is no explicit Directive requirement that share premiums must be paid up, instead of called-up.

Insurance


61. The available solvency margin shall consist of assets of insurance undertakings which are free of any foreseeable liabilities, diminished by the amount of intangible assets and own shares directly held by the insurance undertaking.

62. Unlimited recognition is given to paid-up share capital - except for cumulative preference shares whose eligibility for the available solvency margin is limited (see Chapter 2).

Article 27 2. (a) of the Recast Life Directive 2002/83/EC and Article 16 2.(a) of Directive 73/239/EEC as amended - Initial or foundation fund and members’ accounts

63. Mutual insurance is a form of insurance system based on the ‘mutual society’ legal form. The policyholders of a mutual insurer are its members. Mutual insurers cannot issue shares that would represent a ‘share’ in the ownership of the company. Consistently, they do not distribute dividends; in case of profits, these or part of them may be shared among the mutual’s members.

64. The initial or foundation fund and subordinated members’ accounts (as well as potential supplementary members’ calls) are mutuals specific forms of capital and provide a key source of their available solvency margin as well as allowing new mutuals to be established.
65. The paid-up part of the initial or foundation funds of mutuals (in both the life and non-life sectors) is recognised in the available solvency margin without limit.

66. The recognition of subordinated members' accounts (again in both the life and non-life sectors) is also unlimited, provided that they meet the criteria set out in the Insurance Directive:

   a. the Memorandum and Articles must stipulate that payments may be made from these accounts to members only in so far as this does not cause the available solvency margin to fall below the required level, or, after the dissolution of the undertaking, if all the undertaking's other debts have been settled;

   b. the Memorandum and Articles must stipulate with respect to any payments referred to in point (a) for reasons other than the individual termination of membership, that the competent authorities must be notified at least one month in advance and can prohibit the payment within that period; and

   c. the relevant provisions of the Memorandum and Articles of Association may be amended only after the competent authorities have declared that they have no objection to the amendment, without prejudice to the criteria stated in points (a) and (b).

1.2. Both sectors consider capital subscribed and paid-up by shareholders of the entity, eligible without limit. The treatment of unpaid capital elements is the main difference between the two sectors.

67. Both sectors include capital subscribed and paid-up by shareholders of the entity without limit.

68. In general, the definitions of paid-up capital in both sectors are similar. Differences mainly result from national accounting standards and corporate law which can have different effects on the two industries within one Member State and especially between Member States.

69. Variations in what constitutes capital arise from two main factors:

   a. while Directive 2006/48/EC makes an explicit reference to equity as contained in the Bank Accounts Directive, the Directives applicable to the insurance sector do not refer to the accounting Directives, mainly for historic reasons,

   b. the corporate structure of the entities, as well as national legal framework, may vary between Member States.

70. On the basis of the Bank Accounts Directive, contributed equity capital is generally regarded as capital. However, the Bank Accounts Directive just contains the notion of equity but do not define what makes up equity in detail and what differentiates it from liabilities. It
is therefore up to national law to distinguish eligible capital under this section from other elements e.g. from liabilities.

71. If a member state has introduced IFRS as a basis to determine regulatory capital, the differentiation between equity and liabilities might be drawn from IAS 32.11. The equity definition according to IAS 32.11 focuses on the permanent availability of resources; whenever an entity cannot avoid or permanently defer settlement of a claim, that claim is considered a liability. The distinction is made on a going concern basis; neither the ranking of claims nor the sharing of profits and hidden reserves during liquidation are considered relevant criteria. Therefore, the “legal equity” of certain cooperatives or partnerships is considered a liability when the resources can be withdrawn on the holder’s initiative. IFRIC 2 contains further guidance on how withdrawal must be restricted to classify such capital as equity. CEBS and CEIOPS recommended the use of prudential filters for equity (see Chapter 7 below).

72. In the insurance sector, there are different possible transpositions. Some Member States have transposed the Insurance Directives in a way similar to the banking sector. When defining shareholder capital, they refer to accounting equity, although the Directives do not contain a specific requirement to do so. In some Member States, shareholder capital is defined with reference to national corporate law; the focus may in such a case be drawn away from the economic characteristics of the instrument and mainly based on the legal nature of the relationship between the insurance company and its contributors.

73. To fulfil the paid-up condition, there must be an inflow of resources and not a receivable against the shareholder which would carry uncertainty of collection. The paid-up condition does not necessarily have to be satisfied by a cash inflow as contributions in kind are generally accepted as share capital. Receivables, illiquid assets and goodwill are examples of those contribution in kind (goodwill would be subject to deduction as a next step). Whereas Article 7 of Directive 77/91/EEC limits contributions in kind to discernable assets for certain types of corporations, IFRS 2 and several national GAAP’s allow contributions in kind in the form of rendering services (e.g. employee stock options). Thus, national corporate law provides the details of when contributions in kind are considered to be paid up.

74. Share premiums are mentioned as a separate item in Directive 2006/48/EC, whereas they are part of shareholders’ capital in the Insurance Directives.

75. Cumulative preference shares are excluded from paid-up capital in both sectors and treated as a lower quality capital item (see below, Chapter 2).

76. The treatment of unpaid capital elements is the main difference between the two sectors.

77. Unpaid capital is not taken into account in original own funds of institutions. Members’ commitments to credit institutions set up as
cooperative societies as defined in Article 57(g) of Directive 2006/48/EC and Article 64(1) are only eligible as additional own funds i.e. subject to limit. The CEBS report noted that a very limited number of Member States allowed the inclusion of such commitments. In CEIOPS questionnaire, special attention has been drawn to understand and assess the extent to which members calls are treated in the insurance sector.

78. Under the current Insurance Directives, a limited amount (outstanding and the solvency margin) of the unpaid share capital or initial/foundation fund might be taken into account subject to prior approval by the supervisory authority and provided that a certain percentage has already been paid-up.

2. (Statutory) Reserves

2.1. Description of the characteristics of the (statutory) reserves in the banking and insurance sectors

Banking

<table>
<thead>
<tr>
<th>Item (b) of Article 57 of Directive 2006/48/EC - Reserves within the meaning of Article 23 of Directive 86/635/EEC</th>
</tr>
</thead>
</table>

79. Article 23 of Directive 86/635/EEC sets out that reserves shall comprise all the types of reserves listed in Article 9 of Directive 78/660/EEC under Liabilities item A.IV, as defined therein. Member States may also prescribe other types of reserves if necessary for credit institutions the legal structures of which are not covered by Directive 78/660/EEC. In this context, reserves in the banking sector include:

(1.) legal reserve, in so far as national law requires such a reserve,
(2.) reserve for own shares, in so far as national law requires such a reserve,
(3.) reserves provided for by the Articles of Association, and
(4.) other reserves.

80. Reserves include retained earnings; however additional contributions of equity from outside investors may also be included.

81. As earnings can only accumulate for equity instruments, the debt/equity boundary under national accounting and corporate law is the key element of the definition. The definition of reserves is therefore closely dependent on the definition of paid-up capital.

82. As set out in Article 61 of Directive 2006/48/EC, reserves must be available for unrestricted and immediate use to cover risks and losses as soon as they occur. This rule implies there should be no obligation to transfer retained earnings.
83. According to Article 61, reserves must also be calculated net of any foreseeable tax charge. This requirement only applies if profits have not been adequately reduced by actual or deferred tax charges under national GAAP, which is generally redundant when applying IAS 12.

84. A reserve for own shares is sometimes set up when a company buys in its own shares and capitalises them as an asset in accordance with Article 22(1)(b) of Directive 77/91/EEC; this treatment prevents dilution of the company’s capital by binding profits to the company which would otherwise be distributable.

85. Although this reserve is accepted as a capital element under Article 57(b) of Directive 2006/48/EC, own funds are then reduced by deducting the capitalised book value of own shares under Article 57(i).

86. As an alternative, the acquisition of own shares can be booked as a reduction in share capital and share premiums applying the treatment e.g. under IAS 32. In that case, own shares are not capitalised as assets and there is no deduction under Article 57(i).

87. Both accounting methods have the same net effect on core original own funds: they are reduced by the purchase cost of own shares.

---

**Item (c) of Article 57 of Directive 2006/48/EC – funds for general banking risks within the definition of Article 38 of Directive 86/635/EEC**

88. Although not strictly part of the ‘reserves’, the fund for general banking risks is economically equivalent to a profit reserve; therefore, it is accepted as capital without limits.

89. It includes those amounts which an institution decides to put aside to cover general risks associated with banking.

90. According to IAS/IFRS, the setting aside of amounts in respect of general banking risks is not an expense but an appropriation of retained earnings, and as such, a transfer to reserves (whereas according to Article 38 of Directive 86/635/EEC, the increase and decrease in such amounts must be recognised in the profit and loss account). Therefore, amounts formerly shown as funds for general banking risks are no longer considered as ‘provisions’ but must be transferred to the reserves.

---

**Insurance**


91. Reserves that are not matched to underwriting liabilities are included without limits in the available solvency margin, provided that they are statutory and free. They generally consist of

1. legal reserves, if national law requires such a reserve,
2. reserves for own shares, if national law requires such a reserve,
3. reserves provided for by the Articles of Association, and
4. other reserves.

92. Reserves encompass retained earnings which are free of foreseeable liabilities, i.e. there should be no obligation to transfer them.

93. The absence of foreseeable liabilities also implies that reserves must be calculated net of any foreseeable tax charge, which only applies if profits have not been adequately reduced by actual or deferred tax charges under national GAAP.

94. Even if it is not explicitly mentioned in the Directives, the reserve for own shares is accepted as a capital element. Nevertheless, the available amount of capital is reduced by deducting the value of own shares directly held by the undertaking under Article 27.2 (a) and Article 16.2.

2.2. The notion of reserves is similar in the insurance and the banking sectors. Differences in the types and denominations of legal and statutory reserves arise as the result of different national company laws.

95. Since only equity instruments accumulate profits, reserves are linked to the applicable definition of equity.

96. The Banking Directive states that reserves shall be net of any foreseeable tax charges at the moment of their calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses. Under the Insurance Directives, this is implied by the condition that reserves must be free of any foreseeable liabilities.

97. Differences – in an economic sense – are mainly due to different accounting standards since the determination of profits and losses (recognition and valuations principles) affects the amounts of profits that can be retained.

98. In its answer to Call for advice 10 (para 10.128), CEIOPS takes the view that “assets should generally be accounted at their market value for the technical provisions” and the valuation of technical provisions for the purposes of calculating the SCR should be compatible with the rules on the calculation of technical provisions to be developed as part of the future solvency framework. It might be possible that – analogously to the treatment under IFRS – equalisation provisions or catastrophe provisions relating to future possible claims are not recognised as liabilities. CEIOPS takes the view that at least the equalisation reserves other than those required by Prudential Directives should be acceptable as an eligible element for solvency purposes. It should also be noted, as stated in Chapter 7 below, that the prudential filter related to equalisation provision is different in the Solvency II context.
3. **Profit and loss**

99. This section combines items that are common to both sectors e.g. profits and losses brought forward but also items that are specific to one sector e.g. trading book profits. The idea is to show how the two sectors treat the outcome in terms of the profit and loss account of their business activities (be it a banking activity, a trading activity or an insurance activity) over the year.

3.1. **Description of the characteristics of items related to ‘profit and loss’ in the banking and insurance sectors**

**Banking**

<table>
<thead>
<tr>
<th>Item (b) of Article 57 of Directive 2006/48/EC - profits and losses brought forward as a result of the application of the final profit or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>100. This item includes accumulated profits and losses – apart from profits designated as reserves – as displayed in the most recent audited annual financial statements.</td>
</tr>
<tr>
<td>101. Profits include profits generated in the recent period, profits carried forward from previous periods, profits obtained from dissolving reserves and profits obtained from a reduction of legal capital elements if allowed by capital maintenance rules - some Member States require supervisory approval.</td>
</tr>
<tr>
<td>102. Dividends which are declared, usually at the Annual General Meeting, are deducted at the time of declaration as the declaration establishes an obligation to transfer the funds. There is no guidance for the period between issuance of audited financial statements and the Annual General Meeting: most Member States include profits but deduct expected dividends by analogy with the interim period rule laid down in Article 57 second to last paragraph of Directive 2006/48/EC. Only a few Member States accept accumulated profits in full without deduction of expected dividends.</td>
</tr>
<tr>
<td>103. As stated by Article 61 of Directive 2006/48/EC, profits brought forward must be available for unrestricted and immediate use to cover risks and losses as soon as they occur; they are calculated net of any foreseeable tax charge.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Second to last paragraph of Article 57- Interim profits-</th>
</tr>
</thead>
<tbody>
<tr>
<td>104. Interim profits are accepted in interim calculations of own funds if the interim profits are verified by the persons responsible for the auditing of the accounts. Although the Directive is not precise on what is meant by ‘verified by persons responsible for the auditing of the accounts’ means, most Member States require the approval of the external auditors– i.e. a review engagement defined e.g. in the</td>
</tr>
</tbody>
</table>
transparency Directive, in Article 5(6) of Directive 2004/109/EC or under international auditing standards (ISA) to be adopted by the EU.

105. Interim profits must be evaluated in accordance with the principles of Directive 86/635/EEC. This means that they must follow applicable accounting rules for annual statements; profit estimates or trends are not sufficient. Interim profits must be net of any foreseeable charge or dividend.

106. The reference to the principles of Directive 86/635/EEC can only apply to entities using national GAAP – for entities applying IFRS this will mean conformity with IFRS. There is not yet any guidance as to whether the simplifications of IAS 34 for interim reports are sufficient, which would be the case e.g. under Article 5(3) of the transparency Directive 2004/109/EC.

Art 13 (2)(b) of Directive 2006/49/EC - Net trading book profits net of any foreseeable charges or dividends, less net losses on its other business

107. Subject to national discretion, net trading book profits can be included in capital without limit subject to prior approval by the supervisory authority and under certain conditions.

108. Trading book items are commonly valued at fair value for accounting purposes with changes of fair value recognised as profit or loss; only a few Member States apply a different national GAAP treatment. Despite their recognition in the profit and loss account, changes in fair value are not the result of market transactions.


- a Member State might fully accept the accounting treatment and consider trading gains and losses as part of accounting profit or loss. In that case, they are included in the profit and loss account carried forward or in profit reserves (“Tier 1”, Article 57(b) of Directive 2006/48/EC).

- a Member State might exclude net trading book profits from core original own funds and treat them as capital to cover the capital requirements of the trading book (“Tier 3”, Article 13(2)(b) of Directive 2006/49/EC). However, net profits must not be counted twice – as “Tier 3” in the sense of Article 13(2)(b) of Directive 2006/49/EC and as “Tier 1” under Article 57(b) of Directive 2006/48/EC.

110. Net trading book profits must be free of any foreseeable dividends and tax charge.

111. The trading book definition in Article 11 of Directive 2006/49/EC is not identical to the trading category for accounting purposes (e.g. gains and losses from internal contracts under Article 11(5) are usually not displayed in financial statements). Furthermore, IAS 39.9 classifies derivatives as trading irrespective of the trading intent required by Article 11(1).
112. In the banking sector the Directive explicitly requires institutions to deduct any (material) losses from core original own funds to maintain the ‘integrity’ of their regulatory capital.

113. This deduction applies to both interim losses and losses included within the year-end financial statements. In the latter case, deduction is only required if year-end losses do not automatically reduce an eligible capital element e.g. deduction in case of a net loss carry forward, no deduction if an eligible net profit carryforward is reduced.

114. The deduction requirement means that at least material losses have to be deducted. This does not mean that non-material losses are irrelevant. Sufficient own funds must be provided at all times, as stated in Article 75 of Directive 2006/48/EC, so interim losses have to be monitored on a continuing basis irrespective of their materiality.

Insurance

115. This item refers to accumulated profits and losses brought forward and not designated as reserves. Dividends to be paid have to be deducted. Accumulated profits include those generated in the recent period, those carried forward from previous periods as well as profits obtained from dissolving reserves.

116. Profits include profits generated in the recent period, profits carried forward from previous periods, profits obtained from dissolving reserves and profits obtained from a reduction of legal capital elements if allowed by capital maintenance rules – some Member States require supervisory approval.

117. The absence of foreseeable liabilities for eligible capital elements implies that foreseeable tax charges have to be deducted.

118. As stated in Articles 27 2.(c) and 16 2.(c), dividends to be paid have to be deducted from profit or loss brought forward.

119. In so far as authorised under national law, profit reserves appearing in the balance sheet where they may be used to cover general losses which may arise and where they have not been made available for distribution to policy-holders are also included in the solvency margin.

120. This item comprises the participation fund surplus which is retained earnings attributable to a class of with-profits policyholders. These earnings may for example result from prudence in the
assumptions underlying the technical calculations. Those parts of the participation fund surplus which have already been irrevocably assigned to policyholders do not count as eligible capital, whereas the remaining parts might be taken into account as eligible capital in those cases where, under national law, these amounts may be used to cover general losses i.e. the amounts are not restricted to covering losses in respect of specific groups of policyholders.

3.2. The treatment of profits and losses as eligible capital is very similar in the banking and insurance sectors

121. In both cases, proposed dividends must be deducted. The Banking Directives specify the treatment of expected dividends for interim periods. Expected tax charges are deducted, but this is usually redundant because profits are usually determined after tax in the financial accounts.

122. If trading activities are accounted for at fair value with gains and losses taken through the profit and loss account, unrealised gains (and losses) may become part of profits eligible as capital (See CEIOPS recommendation on prudential filter and Chapter 7 below). However, trading activities play a smaller role in the insurance sector. Although insurance companies don’t have a regulatory trading book, they can have a trading category for accounting purposes (IAS 39.9). However, this trading category is usually not significant. Therefore, net trading book profits mainly concern the banking sector. Even if trading activities are not accounted for at fair value, unrealised profits might be eligible as part of hidden net reserves (see below) for insurance companies.

123. Whereas interim profits are covered in the Banking Directives, there is no common rule for the insurance sector. Nevertheless, eligible capital has to be available on a continuous basis in both sectors, therefore continuous monitoring of eligible elements is generally required.

124. The Banking Directive explicitly requires deduction of material interim losses; this would be consistent with continuous monitoring of eligible elements in the insurance sector: although not explicitly mentioned in the Insurance Directives, ‘material losses of the current year’ are implicitly taken into consideration.

125. Whereas eligible interim period profits must be verified by auditors and calculated according to the applicable accounting rules in application of Article 57, deduction of material losses needs no verification. All losses (not just those that are material) are deducted in the insurance sector because the calculation is based on the current profit and loss rather that the last set of audited accounts as in banking.
4. Reserves for Unrealised Profits and Hidden Reserves

126. This section combines items whose ‘denominations’ are mainly specific to each sector. The main purpose is to compare how the two sectors treat reserves for unrealised profits and hidden reserves, whatever their respective ‘denomination’ in the two sectors.

4.1. Description of the characteristics of the reserves for unrealised profits and hidden reserves in the banking and insurance sectors

127. To compare Revaluation reserves in the banking sector with the insurance sector -where such reserves are not explicitly mentioned but in practice recognised, and because of their similarities with other reserves, these items are covered in this chapter.

128. The approach to ‘unrealised reserves’ is similar in the insurance and in the banking sectors. It is only the extent to which such reserves are included in regulatory own funds that differs: in the banking sector, they are considered as ‘additional own funds’ and only up to a certain limit. In the insurance sector, there is no limit to their inclusion.

129. With regard to ‘hidden reserves’, i.e. unrealised gains not shown in the balance sheet, they are recognised in the insurance sector as capital only upon application to and with agreement of the competent authority, with supporting evidence that the hidden net reserves are not of an exceptional nature.

130. The banking sector only accepts unrealised profits and losses recognised in the balance sheet.

Banking

<table>
<thead>
<tr>
<th>Item (d) of Article 57 of Directive 2006/48/EC - Revaluation reserves within the meaning of Article 33 of Directive 78/660/EEC</th>
</tr>
</thead>
</table>

131. The definition of own funds in the banking sector includes revaluation reserves in the meaning of Article 33 of the Fourth Company Law Directive 78/660/EEC, as stated by Article 57(d) of Directive 2006/48/EC. The reference to Directive 78/660/EEC has not been adapted to the new Article 42a (5a) in Directive 78/660/EC as amended by OJ L 224/11 of 16 August 2006, under which revaluations and revaluation reserves defined in IAS 39 are permitted in national accounting standards.

132. Revaluation reserves in the banking sector are only eligible with limits. The limits are set out in Article 66 of Directive 2006/48/EC. Revaluation reserves belong to core additional own funds.
133. Revaluation reserves within the meaning of Article 33 of Directive 78/660/EEC cover those arising from
   • tangible fixed assets with limited useful lives,
   • stocks, and
   • fixed assets in general.

134. These revaluation reserves are subject to national accounting rules; therefore, eligibility for own funds is also subject to them being recognised in accounting rules.

135. Under IFRS, similar revaluation reserves are established in the balance sheet. The main valuation categories for such reserves are available for sale financial assets (IAS 39.9) and property, plant and equipment when applying the revaluation model (IAS 16.31). IFRS also allow other reserves which are rather rare in the banking sector e.g. IAS 38.75, IAS 19.93A.

136. In some cases except for the trading book, IFRS allow revaluations to be taken through the profit and loss account. Two examples are the fair value option in IAS 39 and investment property accounted for by the fair value model in IAS 40.33. Although unrealised profits do not appear in a special revaluation reserve under IFRS, CEBS has issued guidance on accepting unrealised gains from those revaluations (see Chapter 7 for more details).

137. Revaluations might either result from unrealised gains or from unrealised losses recognised in the balance sheet. Unrealised gains lead to a positive revaluation reserve and generally increase own funds – subject to certain limitations. Unrealised losses can result in a negative revaluation reserve (loss reserve) if they are not recognised as an expense under national accounting rules. The Directive contains no explicit provisions on how to treat negative revaluation reserves. Not taking them into account might contradict Article 61 of Directive 2006/48/EC as own funds would not be fully available to cover losses. CEBS has issued guidance on negative reserves resulting from available for sale financial instruments under IAS 39 (see Chapter 7 for more details).

138. Article 64(4) addresses two special forms of unrealised gains and losses under IFRS: the reserve for cash flow hedge accounting and unrealised gains and losses from own liabilities attributable to changes in the company’s own credit risk. Such unrealised gains and losses are eliminated and therefore not treated as a revaluation reserve (see Chapter 7 for more details).

139. Article 57(e) of Directive 2006/48/EC accepts value adjustments as core additional own funds up to 4% of the total amount of these assets. They result from an intentional undervaluation of certain financial assets in accounting, permissible under Article 37(2) of Directive 86/635/EEC. They follow a different
logic than revaluation reserves which result from unrealised gains or losses.

140. In economic terms, intentional undervaluations have the character of profit reserves, but they are not shown in the balance sheet. Intentional undervaluations have been criticised as a means for profit smoothing as they can be used to offset losses by reversing them. IFRS do not allow intentional undervaluations, therefore ‘value adjustments’ must not be maintained under IAS/IFRS. They will probably be transferred to reserves in original own funds.

141. Practices in recognising unrealised profits or losses and in their presentation in reserves or in profit and loss differ. Such differences make revaluation reserves difficult to compare. IFRS tend to bring more homogeneity as revaluations will be based on a single, detailed set of accounting rules (especially IAS 39, IAS 40 and IAS 16); therefore, criteria for revaluations will no longer be based on national discretion available under the Accounting Directives.

Insurance

Article 27 4. (c) of the Recast Life Directive 2002/83/EC and Article 16 4. (c) of Directive 73/239/EEC as amended – hidden net reserves arising out of the valuation of assets

142. Revaluation reserves related to unrealised gains and losses can be recognised in the insurance sector. These relate to the difference between current market values of investments and the value of the investments on the financial statement balance sheet.

143. Under the current regime, hidden net reserves arising out of the valuation of assets may be included in the available solvency margin, in so far as such hidden net reserves are not of an exceptional nature. Their amount is not limited by the Directives, but their recognition by the competent authority is required, and supporting evidence of their existence is a prerequisite.

4.2. Both sectors include unrealised gains and losses in eligible capital, but the extent to which they are included is different

144. In the insurance sector, there are no explicit limits on accepting revaluation reserves. In the banking sector, revaluation reserves are recognised as additional own funds (limited to 100% of original own funds) only up to a certain limit (e.g. 45% of the difference between book value and current market value). As a general rule, they do not need supervisory approval to be included as capital.

145. As set out above, concerning hidden reserves in eligible capital, i.e. unrealised gains not shown in the balance sheet, they are recognised in the insurance sector as capital only upon application to and with agreement of the competent authority, with supporting
evidence that the hidden net reserves are not of an exceptional nature.

146. The banking sector only accepts unrealised profits and losses recognised in the balance sheet; the sole exception is intentional undervaluations of certain assets (value adjustments) which do not appear in the balance sheet.

147. As the banking sector usually includes only those revaluation reserves recognised in the accounts and accounting standards differ greatly, the influence of unrealised profits on eligible capital can hardly be compared between Member States. By accepting hidden reserves, the insurance sector is less dependent on applicable accounting standards, but needs additional verification as supporting evidence since hidden reserves are not displayed in an audited balance sheet.

148. It is worth mentioning that particularly in those Member States whose system is based on historical costs, hidden net reserves arising out of the difference between the valuation of assets and their market value may play a major role for some insurers. That is why these items are considered as eligible only subject to prior approval of supervisors. Since the turn-over of the assets of an insurance company tends to be much lower than the turn-over of assets in the trading book of a bank, the amount of hidden net reserves tends to be much higher in the insurance sector. Under IFRS however, the Fair Value Option for ‘held to maturity’ avoids hidden reserves by displaying them in eligible profit henceforth there is no participation for policy holders.
### Treatment of all unrealised profits

<table>
<thead>
<tr>
<th></th>
<th>Insurance</th>
<th>Banks Non-trading book</th>
<th>Banks Trading book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible without limit</td>
<td>Depending on the national accounting framework:</td>
<td></td>
<td>All unrealised profits(^{12}) (these are unrealised profits arising from asset price movements)</td>
</tr>
<tr>
<td></td>
<td>All unrealised profits (including those unrealised profits arising from asset price movements)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>All revaluation reserves including all available for sale (these are unrealised profits arising from asset price movements recognised in the balance sheet)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Profit reserves</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subject to limits</td>
<td></td>
<td>Revaluation reserves including available for sale equities, investment properties and land and buildings (these are unrealised profits arising from asset price movements)</td>
<td></td>
</tr>
</tbody>
</table>
| Subject to supervisory approval | Future profits\(^{13}\)  
Hidden reserves (these are unrealised profits arising from asset price movements not recognised by the balance sheet) |                        |                    |
|                          | Zillmerising amount\(^{14}\)                                             |                        |                    |

\(^{12}\) Can be used only to meet market risk requirements  
\(^{13}\) See Chapter 3  
\(^{14}\) An adjustment in the actuarial value of a long-term insurance policy to spread the cost of acquiring new business over a period of time. See Chapter 4.
Chapter 2. Elements eligible with limits which are common to both sectors

149. Capital elements that do not have the same strength and quality as paid-up Capital and (Statutory) Reserves as addressed in Chapter 1, must fulfil conditions and criteria in order to be considered as eligible for regulatory purposes. These conditions are verified by supervisors\textsuperscript{15}. Moreover, their inclusion into regulatory own funds is subject to limits (See Chapter 4).

150. The first main category of such capital elements are ‘hybrids’ i.e. capital instruments that combine both equity and debt characteristics. These capital instruments have recently been created by banking institutions and insurance entities to raise funds in a cost-efficient and less dilutive way.

151. They have been designed to fit into specific domestic legal and fiscal regimes and to be included in eligible regulatory original own funds.

152. As already indicated in the introduction to the report, these instruments are not addressed or not properly taken into account by the sectoral Directives. However, it has been deemed relevant, given the increasing importance of this market, to identify the similarities and differences in the nature of the instruments and in the extent to which hybrids are given regulatory treatments.

153. The second main category is subordinated cumulative debt instruments. Being cumulative limits their ability to absorb losses in period of stress. They may also contain redemption clauses which make them less permanent than Capital and Reserves. They rank senior to those items.

154. In this chapter, these two main categories are described and the similarities and differences analysed.

\textsuperscript{15} see CEBS report and pending outcome of the CEIOPS questionnaire on supervisory practices in the insurance sector.
1. Hybrids

1.1 Description of the characteristics of hybrids in the banking and insurance sectors

Banking

155. In the banking sector, in the absence of an EU-wide legal text, some Member States have used the international agreement embodied in the Sydney16 press release of 1998 and included new capital instruments (commonly designated as ‘hybrids’ as they mix features of debt and equity) into original own funds on the grounds that they have similar characteristics although they do not have the same strength as core original own funds.

156. The Sydney press release which set out the conditions for these instruments to be considered as regulatory Tier 1 capital while imposing limits on their inclusion. This aimed to set out a framework to help supervisors apply their approach towards these instruments in a consistent way, and consequently ensure a level playing field among internationally active institutions. It produced the first international guidelines for the acceptance of hybrids as original own funds based on features like permanence and loss absorption capacity.

157. Hybrid instruments are designed to fit into specific domestic legal and fiscal regimes and therefore encompass a wide range of instruments with very different features.

158. In Europe, in the absence of an EU-wide legal text, competent authorities in the banking sector did not try to list potentially eligible items but built their assessment of hybrids’ eligibility for original own funds on the Sydney press release, or on qualitative requirements that are very similar or complementary to it.

159. The Sydney press release introduced a qualitative distinction between different components of Tier 1/original own funds. This text stated that “voting common shareholders’ equity and disclosed reserves or retained earnings that accrue to the shareholders’ benefit should be the predominant form of a bank’s Tier 1 capital. The reasons provided for this guideline are the following:

- common shareholders’ funds allow a bank to absorb losses on an on-going basis and are permanently available for this purpose;
- these elements of capital best allow banks to conserve resources when they are under stress because they provide a bank with full discretion as to the amount and timing of distributions; and

16 www.bis.org/press/p981027.htm
- the voting rights attached to common stock also provide an important source of market discipline over a bank’s management

160. Directive 2006/48/EC has not been updated to specify a common treatment of these hybrid instruments, so supervisors have tried to apply consistently a set of three main criteria: permanence, loss absorption and flexibility of payments. However, as the features attached to these instruments differ, the limits to the inclusion of such instruments in original own funds vary between Member States.

161. Such instruments are different from core original own funds as they are endowed with features that weaken e.g. their permanence or their loss-absorption compared to paid-up capital and reserves.

162. However, they usually possess all the following characteristics that differentiate them from additional own funds: no maturity, ranking senior only to ordinary shares, non-cumulative payments, coupons or dividends at the issuer’s discretion in order to absorb losses on an on-going concern basis and in periods of stress.

163. Furthermore, banking supervisors have drawn the line between a core additional own funds instrument and a hybrid instrument eligible to original own funds subject to limit.

164. A higher degree of loss absorption is, besides permanence, the key element which distinguishes the two categories. The main features of core additional own funds instruments that are different from those of hybrids eligible as supplementary original own funds are summarised below:

- coupons are deferrable but cumulative which effectively limits the loss absorbency of the instruments particularly in times of stress. In some countries, the requirement that coupons will be non-cash cumulative is the only feature that differentiates supplementary original own funds from core additional own funds;
- the holders of these instruments with respect to the priority of payments rank below all creditors and senior to shareholders (preference and ordinary shares) and holders of hybrids;
- instruments may have soft maturities (over 30 years) and in some cases may also be amortised; and
- coupon step ups may be set over the limits specified in the Basel press release and take place after a minimum of 5 years with supervisory approval instead of 10 years according to the Sydney Press release.
Insurance

165. The Insurance Directives have not been updated to take account of the development of hybrid instruments.

166. Apart from the provisions of Article 27(3)b of Directive 2002/83/EC and 16(3)b of Directive 73/239/EEC which in fact do not really take into account the hybrid or loss absorbent features of instruments since they limit them to exactly the same limitations as the instruments referred to in Article 27(3)a of Directive 2002/83/EC and 16(3)a of Directive 73/239/EEC, there are no international or European accepted minimum requirements for ‘hybrid instruments’ in the insurance sector. The hybrid features of capital instruments are therefore only taken into consideration by supervisory authorities above the required solvency margin subject to national discretions. Some Member States have made use of the principles established in the Sydney press release as a basis for deciding on the eligibility of such instruments.

167. At its meeting 29 June 2005 the European Insurance and Pensions Committee (EIOPC) discussed possible changes to the prudential treatment of “deeply subordinated debt” under the current Insurance Directives. Subsequently, CEIOPS was asked to consider this proposal from a technical point of view.

168. The proposal suggested modifying the current Insurance Directives to allow, under certain conditions, “deeply subordinated debt” as an eligible element. The proposal points out that the current classification of capital has been blurred by the increasing use of “hybrid capital”, and that it would be sensible to amend the current Directives to take account of this development.

169. The proposal outlines the characteristics for the deeply subordinated debt admissible as Tier 1 capital as:

a) they are “deeply subordinated” in the sense that they rank below other subordinated debts;

b) they are perpetual; the debts can be repaid, but only after a five-year period, and in all cases with the prior consent of the supervisor;

c) there is no step-up of interest;

---


d) the insurance undertaking must not pay an interest where this might endanger the undertaking’s compliance with the Directive; unpaid interest is lost and no longer due; and

e) the issued securities may absorb potential losses: in case of losses, the issuer may reduce the amount of the debt in order to pursue its activity.

170. The proposal is that deeply subordinated debt should be allowed up to 15% of the required solvency margin and, given the financial characteristics, considered separately from perpetual subordinated debts, which should not exceed the current limit of 50% of the solvency margin.

171. Furthermore, the proposal suggests to use the comitology provisions in the current legislation which allow amendments to be made “to take into account developments that justify a technical adjustment of the elements eligible for the available solvency margin” rather than to amend the current Insurance Directives through the full Co-decision Procedure, or to wait for the change to be made eventually under the Solvency II Framework Directive.

172. Following due consideration CEIOPS\textsuperscript{19} recognised that the characteristics of subordinated debt instruments vary between jurisdictions and hence the industry has argued for a broad definition of such instruments, with principles for eligibility modelled closely on Basel requirements. CEIOPS also noted that there is a strong body of opinion within the industry that would support a more restricted concept if this would facilitate earlier implementation. However, CEIOPS stressed that any changes made to the definition of eligible capital elements under Solvency I should not prejudge their treatment under Solvency II.

173. Finally, CEIOPS considered the technical merits of the proposal and concluded the proposal is technically feasible. CEIOPS supports the aim of achieving cross-sectoral consistency on the definition of capital. This proposal will serve as an interesting input in the design of Solvency II.

1.2. Hybrids are not consistently treated across the two sectors

174. In absence of EU-wide text in the two sectors, the approaches to and treatment of hybrids differ across Member States and across sectors.

175. In the banking sector, Member States have used the Sydney press release to recognise hybrid instruments as original own funds.

\textsuperscript{19} Advice to the European Commission on the treatment of “deeply subordinated debt”, CP 12, available at: \url{http://www.ceiops.org/content/view/14/18/}. 
Hybrids may be recognised subject to national discretion, to cover the capital requirements of an institution.

176. When Member States recognise hybrid instruments as eligible, two different situations exist (see Chapter 4 for more details):

1. the majority of members apply a 15% limit to hybrids with incentives to redeem, consistent with the Sydney Press release,

2. differences are wider with regard to the limit on the total of hybrid instruments (taking into account also hybrids with incentives to redeem), which can reach 50%.

177. In the insurance sector, hybrid features of instruments are taken into consideration by supervisors only where these instruments are in excess of the required solvency margin, according to national discretion. The extent to which they are taken into consideration also varies. Some Member States have made use of the principles established in the Sydney press release as a basis for deciding on the eligibility of such instruments.
2. Instruments eligible in both sectors which are subject to conditions and limits

2.1. In the two sectors, instruments must fulfil conditions as set out in the Directives to be considered as eligible

Banking

178. Capital elements with limited recognition are called additional own funds – or Tier 2- according to Article 57 of Directive 2006/48/EC. They are (using the references of Article 57):

<table>
<thead>
<tr>
<th>Article 57, item:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(d) revaluation reserves within the meaning of Article 33 of Directive 78/660/EEC;</td>
</tr>
<tr>
<td>(e) value adjustments(^{20}) within the meaning of Article 37(2) of Directive 86/635/EEC;</td>
</tr>
<tr>
<td>(f) other items within the meaning of Article 63 (1)(^{21}) and Article 63 (2);</td>
</tr>
<tr>
<td>(g) the commitments of the members of credit institutions set up as cooperative societies and the joint and several commitments of the borrowers of certain institutions organised as funds, as referred to in Article 64(1)(^{22}); and</td>
</tr>
<tr>
<td>(h) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 64(3).</td>
</tr>
</tbody>
</table>

179. With regard to Revaluation reserves, as indicated in Chapter 1, they are included provided that the assets are considered by supervisory authorities to be prudently valued, i.e. fully reflecting the possibility of price fluctuations and forced sale. Moreover, as set out in Chapter 7 below, positive fair value revaluation reserves for institutions applying IAS/IFRS rules can be partially included in additional own funds.

180. Unlike in the insurance sector, revaluation reserves in the banking sector are subject to limits.

181. Article 64(1) on Commitments of the members of credit institutions set up as co-operative societies” shall comprise those societies’ uncalled capital, together with the legal commitments of the members of those cooperative societies to make additional non-refundable payments should the credit institution incur a loss, in

---

\(^{20}\) Already addressed in Chapter 1.

\(^{21}\) Addressed in Chapter 3 below as an element specific to the banking sector.

\(^{22}\) Already partly addressed in Chapter 1.
which case it shall be possible to demand those payments without delay. The joint and several commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items. All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law.

182. In the insurance sector, a mutual may call under no other restriction than those that may be stipulated in the articles of association or in the insurance contract.

183. Supplementary additional own funds as defined in Article 57(h) are the lowest form of eligible regulatory capital compared to core additional own funds as defined in Article 57 (f):

a. They do not necessarily cover losses on a going concern basis

b. They are not permanent: they may have a fixed maturity and

c. They do not give full discretion to the issuer as to the flexibility of payments: they are cumulative

184. These instruments must fulfil a set of conditions laid down in Directive 2006/48/EC in order to be eligible.

Insurance

The available solvency margin (= capital) elements of insurers with limited recognition but without prior authorisation are covered by Article 16(3) of Directive 73/239/EEC, as amended, and Article 27(3) of Directive 2002/83/EC

185. The Directive provides that the available solvency margin may also consist of: (…). As a consequence, national legislation may be stricter than the Directives. For instance, the latter provide that the available solvency margin may consist of cumulative preferential share capital; in a number of Member States such a feature does not exist.

186. Revaluation Reserves” and, “Value Adjustments”, are not explicitly mentioned in the Insurance Directive but in practice, they can be recognised as eligible by Member States. They have been addressed in Section 4 of the previous Chapter.

187. Elements eligible with limits are:

   (a) Cumulative preferential share capital and subordinated loan capital (see Chapter 4 for the extend to which these items are included); and

   (b) Securities with no specified maturity date and other instruments, including cumulative preferential shares other than
those mentioned in (a) (see Chapter 4 for the extent to which these items are included).

188. It should be noted that among those Tier 2 instruments, revaluation reserves, value adjustments, commitments to cooperative societies are not fully comparable between the two sectors. Only cumulative preference shares/securities, instruments of indeterminate duration and with fixed term are truly comparable between the two sectors.

189. In consistency with the Banking Directives, CEIOPS recommends in its CP 20 to classify as Tier 2 those capital elements which still provide a certain degree of loss absorbency, either during ongoing operations or during insolvency/winding-up only, including subordination to the rights (and reasonable expectations) of policyholders, but which does not meet the requirements for permanence and absence of fixed servicing costs and hence are of lower quality than Tier 1 capital.

190. CEIOPS advises further to subdivide Tier 2 according to the permanence of the capital elements it contains:

- Upper Tier 2 capital. which is perpetual, and
- Lower Tier 2 capital, which is dated.

2.2. Securities of indeterminate duration/perpetuals with loss-absorption capacity and non-fixed term cumulative preference shares meet similar (if not identical) eligibility criteria

<table>
<thead>
<tr>
<th>Insurance</th>
<th>Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Securities with no specified maturity date and other instruments, including cumulative preferential shares other than those mentioned in Article 16 3. (a) of Directive 73/239/EEC, as amended, and Article 27 3. (a) of Directive 2002/83/EC</strong></td>
<td><strong>Securities of indeterminate duration and other instruments, cumulative preferential shares other than those referred to in Article 57(h) of Directive 2006/48/EC</strong></td>
</tr>
<tr>
<td>i) must not be repaid without the prior consent of the supervisor;</td>
<td>(a) may not be reimbursed on the bearer’s initiative or without prior agreement of the supervisory authority</td>
</tr>
<tr>
<td>ii) the contract must enable the insurer to defer the payment of</td>
<td>(b) the debt agreement must provide for the credit institution to</td>
</tr>
</tbody>
</table>

---

23 Article 16 3. (b) of Directive 73/239/EEC, as amended, and Article 27 3. (b) of Directive 2002/83/EC,  
24 Article 57(f) and Article 63(2) of Directive 2006/48/EC
<table>
<thead>
<tr>
<th>interest</th>
<th>have the option of deferring the payment of interest on the debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>iii) the lender’s claim on the insurer must rank entirely after those of all non–subordinated creditors;</td>
<td>(c ) the lender’s claim on the credit institution must be wholly subordinated to those of all non–subordinated creditors</td>
</tr>
<tr>
<td>iv) the [contract] must provide for the loss–absorption capacity of the debt and unpaid interest, while enabling the insurer to continue its business;</td>
<td>(d ) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading; and</td>
</tr>
<tr>
<td>v) only paid–up funds are taken into account.</td>
<td>(e ) only fully paid up amounts shall be taken into account. The requirements must usually be cumulative</td>
</tr>
</tbody>
</table>

191. The main difference lies in the fact that perpetual subordinated loan capital in the banking sector must meet two mandatory requirements: a minimum maturity of five years and the reimbursement is subject to prior supervisory approval. In the insurance sector, such instruments must meet the requirement that it may only be repayable subject to five years' notice unless the loans are no longer considered as a component of the available solvency margin, or unless the prior consent of the competent authorities is specifically required for early repayment.

192. In the latter event the insurance undertaking must notify the competent authorities at least six months before the date of the proposed repayment, specifying the available solvency margin and the required solvency margin both before and after that repayment. The competent authorities shall authorise repayment only if the insurance undertaking's available solvency will not fall below the required level.

2.3. Subordinated loan capital and fixed-term cumulative preference shares must meet requirements which are broadly similar in the two sectors

---

25 In the banking sector, subordinated loan capital instruments eligible as supplementary additional own funds have usually a fixed maturity (maturity must be of at least five years). They may be initially undated but their early repayment is subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. In the latter case, the competent authority may grant permission for early payment provided that the request is made at the initiative of the issuer and the solvency of the institution is not affected.
<table>
<thead>
<tr>
<th><strong>Insurance</strong>&lt;sup&gt;26&lt;/sup&gt;</th>
<th><strong>Banking</strong>&lt;sup&gt;27&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cumulative preferential share capital and subordinated capital as referred to Article 16 3. (a) of Directive 73/239/EEC, as amended, and Article 27 3. (a) of Directive 2002/83/EC</strong></td>
<td><strong>Fixed term cumulative preferential share capital and subordinated loan capital referred to in Article 57(h)</strong></td>
</tr>
<tr>
<td>In the event of the bankruptcy or liquidation of the insurer, the subordinated loan or preferential share capital ranks after the claims of all other creditors and is not to be repaid until the settlement of all other outstanding debts;</td>
<td>There must be binding agreements under which, in the event of the bankruptcy or liquidation of the credit institution, the subordinated loan capital ranks after the claims of all other creditors and is not to be repaid until all other debts outstanding at that time have been settled</td>
</tr>
<tr>
<td>Only paid–up funds are taken into account;</td>
<td>a) Only fully paid-up funds may be taken into account</td>
</tr>
<tr>
<td>The original maturity must be at least 5 years. No later than 1 year before repayment: the insurer must submit for the supervisor’s approval a plan showing how the available solvency margin will be kept at the required level, unless the part of the loan ranking as a component of the available solvency margin is gradually reduced during the last 5 years before repayment. On application, the supervisor may authorize early repayment provided the available solvency margin will not fall below the required solvency margin.</td>
<td>b) The loan capital must have an original maturity of at least five years, after which it may be repaid</td>
</tr>
<tr>
<td>c) The extent to which they may rank as own funds shall be gradually reduced during at least five years before the repayment date;</td>
<td>d) The loan agreement must not include any clause providing that in specified circumstances other than the winding-up of the credit institution, the debt shall become repayable before the agreed repayment date</td>
</tr>
<tr>
<td>Loans without fixed maturity must be repayable only subject to 5 years’ notice, unless:</td>
<td>For the purpose of point (b) If the maturity is not fixed, the capital can only be repaid after a five year long</td>
</tr>
</tbody>
</table>

---

<sup>26</sup> Article 16 3. (a) of Directive 73/239/EEC, as amended, and Article 27 3. (a) of Directive 2002/83/EC.

<sup>27</sup> Article 57(h) and Article 64(3) of Directive 2006/48/EC.
they are no longer considered to be a component of the available solvency margin, or – the prior consent of the supervisor is specifically required for each repayment. In that case the insurer must notify the supervisor at least 6 months before repayment; the supervisor shall authorise repayment only if the insurer's available solvency margin will not fall below the required level.

The loan agreement may be amended only if the supervisor does not object to the amendment.

| period of notice unless the loan capital is no longer included in own funds or with the competent authorities' prior consent to the repayment |
| The competent authorities may grant permission for the early repayment of the loan capital if the request is made at the initiative of the issuing bank and the solvency of the institution is not affected |

193. With respect to Fixed-term/dated subordinated loan capital the differences between the banking sector and the insurance sector are related to the treatment required in the last five years before repayment.

194. In the banking sector the loan capital must be amortised during the last five years before repayment, e.g. with a yearly deduction of 20 percent of the amount of the loan capital.

195. In the insurance sector the insurance undertaking needs supervisory approval for their plan regarding the available solvency margin one year before the repayment date, unless it gradually deducts the subordinated loan capital from the solvency margin during the 5 years before repayment.

196. In the insurance sector, the loan agreement may be amended only if the supervisor does not object to the amendment.
Chapter 3. Eligible elements specific to the insurance and banking sectors

197. This chapter describes the items that are not comparable between the two sectors, i.e. capital elements included in the eligible capital of the banking or insurance sector that do not have an equivalent in the other sector.

1. Few elements are intrinsically related to insurance activities- Some of them are to disappear in the new regime of Solvency II

1.1. The elements specific to life insurers are profit reserves, zillmerising amounts and future profits

Profit reserves, Article 27 2. (d) of the Recast Life Directive 2002/83/EC

198. If authorised under national law, profit reserves appearing in the balance sheet where they may be used to cover general losses which may arise and where they have not been made available for distribution to policyholders. This item is admitted without limitation and without authorisation.

199. In CEIOPS’ answer to Call for advice 19 para. 19.51 with regard to the potential treatment of this item under Solvency II, it is stated that Tier 1 capital contains those parts of the participation fund surplus which have not yet been irrevocably assigned to policyholders and may, under national law, be used to cover general losses; also in life insurance, the part of the technical provisions in respect of future benefits to policyholders, provided that under national law these amounts may be used to cover losses and have not yet been made available for distributions to policyholders.

200. It should nevertheless be noted that, since they are in principle, or may be, attributable to with profit policyholders, it is still to be debated under which circumstances they might be admitted as capital, and if so, in which tier.

Zillmerising amounts28, Article 27 4. (b) of the Recast Life Directive 2002/83/EC

201. Zillmerising amounts are elements admitted with authorisation but without pre-set limitation.

202. Where zillmerising is less than the loading for acquisition costs included in the premium, the difference between the actual provision and a provision zillmerised at a rate equal to the acquisition loadings

---

28 An adjustment in the actuarial value of a long-term insurance policy to spread the cost of acquiring new business over a period of time.
included in the premium may be included in the available solvency margin. The figure may not exceed 3.5% of the sum of the differences between the relevant capital sums of life assurance activities and the mathematical provisions for all policies for which Zillmerising is possible. The difference shall be reduced by the amount of any undepreciated acquisition costs entered as an asset.

203. This element should not subsist in Solvency II, due to the new regime for valuation of technical provisions.

**Future profits, Article 27 4. (a) of the Recast Life Directive 2002/83/EC**

204. In addition to the profit and loss figure brought forward, under the current insurance regime, future profits may count as eligible capital, subject to certain limits and subject to prior approval by the home Member State’s supervisory authority.

205. Until 31 December 2009, there is a limit of an amount equal to 50% of the life insurer’s future profits, but not exceeding 25% of the lesser of the available solvency margin and the required solvency margin. The amount of the future profits is obtained by multiplying the estimated annual profit by a factor which represents the average period left to run on policies. The factor may not exceed 6. The estimated annual profit shall not exceed the arithmetical average of the last five annual profits from activities listed in Article 2(1) 29.

206. The supervisor may

– require that an actuarial report substantiating the likelihood of these future profits be submitted; and

– take account of future profits emerging from hidden reserves

207. From 1 January 2010 onwards, future profits will not be accepted as eligible elements of capital. Hence, their role in the assessment of the available solvency margin under the current regime is negligible.

1.2. **Members’ calls are specific to non–life insurers, Article 16 4. (b) of Directive 73/239/EEC, as amended**

208. In the case of mutual non–life insurers with variable contributions, any claims which it has against its members by way of calls for supplementary contributions (members’ calls), within the financial year, are admitted as capital with authorisation and with pre-set limitation (see Chapter 4 for the applicable limits).

---

29 Life insurance, supplementary insurance, permanent health insurance not subject to cancellation.
209. It should be underlined that there is no specific condition on their calling up other than those stipulated in the Articles of Association or in the insurance contract.

2. Equally, there are few elements specific to credit institutions and investment firms

2.1. Some specific items are related to the Capital Requirements Directive and concern Internal Ratings Based institutions

210. Under Article 57(q), institutions using the Internal Ratings Based approach must deduct from own funds the negative difference resulting from the calculation in Annex VII, Part 1, paragraph 36 and expected loss amounts calculated in accordance with Annex VII, Part 1, paragraphs 32 and 33. In accordance with Article 66, the negative amount is deducted half from core original own funds and half from additional own funds.

211. Conversely, through the application of Article 63(3) of Directive 2006/48/EC the positive difference between value adjustments and provisions and expected loss for institutions using the IRB approach, subject to national discretion, may be included up to a maximum of 0.6% of Risk Weighted Assets (RWA). A limit lower than 0.6% may be applied. For institutions that will exercise this discretion, value adjustments and provisions under Article 57(e) shall not be included as core additional own funds.

2.2. ‘General provisions’, ancillary own funds and the deductions related to securitisation transactions are also specific to credit institutions and investment firms

‘General provisions’ referred to in Article 63(1)

212. Article 57(f) in conjunction with Article 63(1) of Directive 2006/48/EC include ‘other items’ as eligible additional own funds. These other items must be freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified; their existence is disclosed in internal accounting records; and their amount is determined by the management of the credit institution, verified by independent auditors, made known to the competent authorities and placed under the supervision of the last named.

213. Examples of such items are general provisions, and in some Member States collective provisions, usually limited to 1.25% of risk weighted assets, or unrealised reserves not included under the category of “value adjustments”.
Ancillary own funds

214. Credit institutions and investment firms can use an alternative definition of capital to meet market risk under Directive 2006/49/EC. This alternative definition includes ancillary own funds which are:

**Short term subordinated loan capital**

215. Article 13 (2)(c) of Directive 2006/49/EC - subordinated loan capital and/or the items referred to in Article 13(5), subject to conditions laid down in the Directive.

216. The relevant conditions are set out in Article 13 (3) and (4) and in Article 14. Subordinated loan capital shall meet five criteria to be eligible as ancillary own funds:

a. it shall have an initial maturity of at least 2 years;

b. it shall be fully paid up;

c. the loan agreement shall not include any clause providing that in specified circumstances, other than the winding up of the institution, the debt will become repayable before the agreed repayment date, unless the competent authorities approve the repayment;

d. neither the principal nor the interest on such subordinated loan capital may be repaid if such repayment would mean that the own funds of the institution in question would then amount to less than 100% of that institution's overall capital requirements; and

e. the competent authorities shall be notified of all repayments of such subordinated loan capital as soon as an institution's own funds fall below 120% of its overall capital requirements.

**Illiquid assets**

217. The alternative definition of own funds allows for, in some cases and subject to national discretion, in accordance with Article 13(2)(d) of Directive 2006/49/EC, the deduction of illiquid assets as specified in Article 15 of that Directive.

218. Illiquid assets\(^{30}\) include the following:

(a) tangible fixed assets (...);

(b) holdings in credit or financial institutions which may be included in own funds (...);

(c) holdings or other investments in undertakings other than credit or financial institutions which are not readily marketable;

(d) deficiencies in subsidiaries;

(e) deposits made, other than those which are available for repayment within 90 days, and also excluding payments in connection with margined futures or options contracts;

\(^{30}\) Please refer to Annex (mapping table) for the exact wording of the elements to be included.
(f) loans and other amounts due, other than those due to be repaid within 90 days;
(g) physical stocks, unless they are already subject to capital requirements at least as stringent as those set out in Arts 18 and 20.

219. With regard to Article 15(b) where shares in a credit or financial institution are held temporarily for the purpose of a financial assistance operation designed to reorganise and save that institution, the competent authorities may waive the application of Article 15. It may also be waived in respect of shares included in an investment firm's trading book.

Deductions related to securitisations

220. As stated by Article 57(r) of Directive 2006/48/EC, the exposure amount of securitisation positions which receive a risk weight of 1250% shall not be deducted if they have been included in the calculation of risk-weighted exposure amounts as specified in Annex IX, Part 4, paragraph 2 of Directive 2006/48/EC.

221. Moreover, CEBS recommends that transactions fulfilling the criteria of Directive 2006/48/EC relating to securitisation should follow the revised prudential framework regardless of the accounting treatment.

222. The last paragraph of Article 57 covers the deduction of net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisation. This deduction is allowed only in the case of a credit institution which is the originator of a securitisation. This is not applicable if the SPV must still be consolidated since no separation of the securitised assets has occurred from group's perspective (elimination of intra group transaction).

223. For further details on these deductions, please refer to Chapter 5 below.
Chapter 4. Limits

224. The purpose of putting limits on eligible capital elements is to maintain a minimum level of quality for regulatory capital.

225. Limits are put on elements of capital which are deemed of lower quality than capital elements eligible without limits but which do have characteristics that -from a supervisory point of view- make them preferable to plain debt instruments.

226. Possible relevant criteria for assessing eligibility of capital for supervisory purposes are the ability to absorb losses in going concern, stress and winding up situations, subordination, absence or deferral of payment of interest or servicing costs and the availability of non-paid-up items which are admitted with prior supervisory authorisation.

227. In this chapter the systems of limits in the banking and insurance sectors are described and the similarities and differences analysed.

1. Limits applicable in the banking sector

228. As indicated above, Directives 2006/48/EC and 2006/49/EC use 'layers' of own funds: original, additional and ancillary own funds, to distinguish between the quality of the eligible elements. In the banking sector reference is also often made to the system of tiers used in the Basel Accord of 1988 and the Sydney Press release to categorise the quality and eligibility of capital.

229. Additional own funds are limited in relation to the amount of available original own funds. Limits also apply within each layer, as described below:

1.1. Hybrid instruments are part of original own funds but subject to limits set by national supervisors

230. Although not specified in the Banking Directives, most Member States apply the limits indicated in the Sydney press release regarding the amount of eligible innovative capital instruments included in original own funds.

231. The Basel principle that "voting common shareholders’ equity and disclosed reserves or retained earnings that have accrued to the shareholders’ benefit should be the ‘predominant’ form of a bank’s Tier 1 capital" could be, and has been, interpreted in some Member States as meaning that core Tier 1 should represent the majority, i.e.
more than 50% of the total amount of Tier 1, therefore recognising hybrids as eligible for up to 50% of total original own funds.

232. Although the Sydney press release clearly fixed a 15% limit for hybrids with step-up, it did not fix an explicit limit for hybrids without step-up.

233. In that context, for innovative hybrid instruments with a step-up feature the limit is usually 15%, while the total of innovative and non-innovative hybrids is limited to percentages up to 50%. A more detailed description and a comparison of national practices on limits can be found in the CEBS report.

234. Depending on the national banking law, the amount of hybrid instruments issued in excess of the limits for inclusion of these instruments in original own funds may be included in additional own funds.

1.2. Additional own funds are subject to the two limits laid down in Article 66 of Directive 2006/48/EC

235. Additional own funds consist of

a. core additional capital (‘upper Tier 2’): revaluation reserves, value adjustments, other items; and

b. supplementary additional own funds (‘lower Tier 2’): commitments of members, fixed term cumulative shares and subordinated loans)

236. According to Article 66

a. Total additional own funds may not exceed 100% of total original own funds and

b. supplementary additional own funds may not exceed 50% of total additional own funds

1.3. Limitations set out in Directive 2006/49/EC for ancillary own funds are very complex

237. Under certain conditions subordinated loan capital with an initial maturity of at least two years may be recognised for covering market risks. The limit system is rather complicated.

238. In accordance with Article 13(4), subordinated loan capital (‘Tier 3’) may not exceed a maximum of 150% of the original own funds left to meet the requirements calculated in accordance with Articles 21 and 28-32 and Annexes I -VI of Directive 2006/49/EC and may approach that maximum only in particular circumstances acceptable to the competent authorities.

239. Under Article 13(5) the competent authorities may permit institutions to replace short term subordinated loan capital with types of capital in (d) to (h) of Article 57 of Directive 2006/48/EC i.e. additional own funds (Tier 2).
240. Under Article 14(1) the competent authorities, if they judge it prudentially adequate, may allow investment firms to hold subordinated loan capital to a maximum of 200% of original own funds left to meet the requirements under Articles 21 and 29-32 and Annexes I and III-VI, or 250% of the same amount where the firm deducts illiquid assets under Article 13(2)(d) when calculating own funds.

241. Under Article 14(2) the competent authorities may allow the ceiling for subordinated loan capital for credit institutions to be raised to a maximum of 250% of original own funds left to meet the requirements calculated in accordance with Article 28-32 and Annexes I and III-VI.

2. Limits applicable in the insurance sector

242. The current life and non-life Insurance Directives contain regulations on the components of the available solvency margin including limits on items of lower quality. The limits apply to the "lesser of the available and the required solvency margin", e.g. a limit up to 50% of the lesser of the available solvency margin and the required solvency margin has to be applied to a number of capital elements.

243. In the context of Solvency II and CEIOPS’ answer to Call for advice 19 and CP 20, the current calculation of limits in the insurance sector is under review.

244. In its CP 20, paras. 4.83 and following, CEIOPS suggests that Tier 1 should consist of core Tier 1 and non-core Tier 1 capital, whereby the latter is furthermore subdivided into non-innovative Tier 1 and innovative tier1 capital (e.g. hybrid capital which provides better loss absorbency than those classified as Tier 2). CEIOPS furthermore recommends that a percentage of eligible Tier 1 capital should be met by the highest quality core capital (e.g. 50%).

245. CEIOPS recommends to classify as Tier 2 those capital elements which still provide a certain degree of loss absorbency, either during ongoing operations or during insolvency/winding-up only, including subordination to the rights (and reasonable expectations) of policyholders, but which does not meet the requirements for permanence and absence of fixed servicing costs and hence are of lower quality than Tier 1 capital.

246. CEIOPS advises further to subdivide Tier 2 tier according to the permanence of the capital elements it contains:
   - Upper Tier 2 capital. which is perpetual, and
   - Lower Tier 2 capital, which is dated.

247. CEIOPS suggests that contingent capital which may only provide a degree of loss absorption in particular circumstances is classified as insurance Tier 3 capital. Its loss absorbency needs to be
assessed by the relevant supervisory authority, based upon clear and transparent principles."

248. In CP 20, paras 4.87 and following, CEIOPS recommends to limit the sum of Tier 2 and insurance Tier 3 capital with respect to available Tier 1 capital (only).

249. Since Tier 1 capital reflects the highest quality available, its overall recognition is not subject to upper limits. However, to ensure that the quality is not diluted too much by non-core Tier 1 capital, and that a sufficient amount of Tier 1 capital is available to cover the SCR, minimum levels are suggested for core Tier 1 capital and the overall level of Tier 1 capital:

- CEIOPS suggests that Tier 1 core capital should form the predominant part (i.e. at least 50%) of Tier 1 capital.

- CEIOPS suggests that an upper limit should be set for the percentage of innovative Tier 1 capital. This limit should be expressed by a pre-specified percentage of Tier 1 capital. CEIOPS recommends that the results from its questionnaire\(^\text{31}\) regarding innovative capital should be reviewed before fixing this limit.

- By limiting the sum of Tier 2 and insurance Tier 3 capital with respect to the available capital, it is ensured that at least 50% of the SCR and 50% of the MCR have to be covered with Tier 1 capital. Therefore, these amounts deliver the minimum level of Tier 1 capital.

250. CEIOPS suggests limiting the sum of Tier 2 and insurance Tier 3 capital that is eligible for inclusion in the available solvency margin, since these forms of capital lack some of the quality of Tier 1 capital (for e.g. they may not be fully loss absorbent on a going-concern and winding-up basis or fulfil the criterion of permanence). CEIOPS furthermore proposes to set the eligible amount of Tier 1 capital as the limit for the sum of Tier 2 and Tier 3 capital.

251. Additionally, under the existing Insurance and Banking Directives, elements of capital that are classified as Tier 2 are split into two categories with respect to their permanence, namely upper and lower Tier 2 capital.

252. CEIOPS recommends that, in addition to the limit set for the sum of Tier 2 and insurance Tier 3 capital, the amount of lower Tier 2 capital that is eligible for inclusion in the available solvency margin shall not exceed 50% of the amount of eligible Tier 1 capital.

253. Potentially, CEIOPS recommends installing a second set of supervisory control levels for undertakings which include Tier 3 capital in their available solvency margin. However, the precise details of the control level system require further consideration by CEIOPS.

254. As stated in para. 4.44 CEIOPS recommends Tier 3 contingent capital elements are not eligible for covering the MCR since they might not be paid in due time in a winding-up situation to facilitate the run-off of the portfolio until a third party takes it over.

255. The limits system under Solvency I is the following:

2.1. Limits applicable to capital eligible without prior supervisory approval

256. According to Article 27 3. of Directive 2002/83/EC and Article 16 3. of Directive 79/239/EEC as amended cumulative preferential share capital (a) and subordinated loan capital (b) are counted up to 50% of the lesser of the available solvency margin and the required solvency margin. No more than 25% of the lesser margin shall consist of subordinated loans with a fixed maturity or fixed term cumulative preferential share capital.

257. Securities with no specified maturity date and other instruments, including cumulative preferential shares other than those mentioned in point (a) are eligible up to 50% of the lesser of the available and the required solvency margin, Article 27 3. (b) of Directive 2002/83/EC and Article 16 3. (b) of Directive 79/239/EEC as amended.

2.2. Limits of capital admitted with prior supervisory approval

258. In accordance with Article 27 4. (a) of the Recast Life Directive 2002/83/EC, until 31 December 2009, an amount equal to 50% of the life insurer's future profits may count as capital, but not exceeding 25% of the lesser of the available solvency margin and the required solvency margin. The amount of the future profits is obtained by multiplying the estimated annual profit by a factor which represents the average period left to run on policies. The factor may not exceed 6. The estimated annual profit shall not exceed the arithmetical average of the last five annual profits in activities listed in Article 2(1).

259. In non-life insurance according Article 4(b) of Directive 73/239/EEC as amended by Directive 2002/13/EC the claims of mutual insurers against their members by way of a call for supplementary contributions within the financial year are limited at up to half of the difference between the maximum contributions and the contributions actually called in, and up to 50% of the lesser of the available solvency margin and the required solvency margin.
260. According to Article 27 4(d) of the Recast Life Directive. 2002/83/EC and Article 4(a) of Directive 73/239/EEC as amended by Directive. 2002/13/EC, the one half of the unpaid share capital or initial fund is admitted as capital once the paid up part amounts to 25% of that share capital or fund, up to 50% of the lesser of the available solvency margin and the required solvency margin.

261. Depending on the interpretation of the Insurance Directives capital admitted with prior authorisation may be included in the limit for capital available according to Article 27 3. of Directive 2002/83/EC and Article 16 3. of Directive 73/239/EEC.

3. Although the limits are based on different reference points and on different level, they are tantamount to the same

262. The main similarity between banking and insurance regulations regarding limits on eligible capital is the fact that additional own funds as defined by the Banking Directive and elements “eligible with limits” according to Article 27 3. of Directive 2002/83/EC and Article 16 3. of Directive 73/239/EEC as amended are limited in a similar way.

263. The percentages used ‘50% of the total margin’ or ‘may not exceed 100%’ potentially have the same impact in the absence of contingent capital.

264. However, the basis of the limits is different. In insurance limits apply to the amount of the lower of required or available capital whereas in banking the limits apply to the tiers.

265. If the required solvency margin is lesser than the available solvency margin, which usually is the case, the insurance limits is more stringent. However, the predominant part of the insurance system shows identical results in cases of solvency deficits32.

Illustration of limitation systems institutions X (Bank) and Y (Insurer):

<table>
<thead>
<tr>
<th>Required solvency (margin):</th>
<th>150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available Tier 1:</td>
<td>100</td>
</tr>
<tr>
<td>Potential Tier 2:</td>
<td>100</td>
</tr>
<tr>
<td>X: surplus 100+100-150=50</td>
<td>Y=: surplus 175-150=25</td>
</tr>
<tr>
<td>SupposeRequired solvency (margin) increases to:</td>
<td>180</td>
</tr>
<tr>
<td>X: surplus 100+100-180=20</td>
<td>Y: surplus 190-180=10</td>
</tr>
<tr>
<td>Suppose Tier 1 decreases to 50</td>
<td></td>
</tr>
<tr>
<td>X: deficit 100-150= -50</td>
<td>Y: deficit: 100-150= -50</td>
</tr>
</tbody>
</table>

32 Further details will be available when the outcome of the CEIOPS current questionnaire on regulatory capital in the insurance sector across the EU will be available.
Chapter 5. Deductions

266. The principles underlying deductions in the banking and insurance sectors are very similar, that is to ensure firstly that the real value of capital items is accurately stated and, secondly, that capital items are only used once to support banking or insurance activities in cases where a bank or an insurer has interests in other banking, financial or insurance undertakings, or in a financial group situation.

267. In this chapter the term 'value deductions' is used to categorise the former type of deduction and "financial group deductions" to categorise the latter.

1. Both sectors ensure that the real value of capital items is adequately stated

1.1. Own shares and intangible assets are deducted in the two sectors

268. In the banking sector Article 57(i) to (k) of Directive 2006/48/EC describe in detail what banks and banking groups must deduct from capital items referred to in Article 57(a) to (c) to give the total amount of original own funds on which the calculation of the limits detailed in Chapter 4 are based. The value deductions are:

(i) own shares at book value held by a credit institution;
(j) intangible assets within the meaning of Article 4(9) ('Assets') of Directive 86/635/EEC; and
(k) material losses of the current financial year; (already addressed in Chapter 1).

269. These items are deducted from original own funds (Tier 1).

270. In the insurance sector similar value deductions are set out in Article 27(2) of the recast life assurance Directive 2002/83/EC and Article 16(2) of the non-life Directive 73/239/EEC as amended by Article 1(2) of Directive 2002/13/EC. The items deducted are:

- own shares directly held by the insurance undertaking; and
- intangible items.

271. As already indicated in Chapter 1, ‘material losses’ are also deducted.
These items are deducted from the total available solvency margin.

1.2. Value deductions are deducted from different reference points

The value deductions are essentially the same in both sectors. In the banking sector value items are deducted from original own funds while in the insurance sector they are deducted from the total available solvency margin. As a consequence these deductions have the same effect only if the banking or insurance group is exactly at its required capital level; if the groups are overcapitalized the banking rule becomes the stricter, while if groups are undercapitalized the insurance rule becomes the stricter one.

2. The deductions of holdings/participations within the same sector follow the respective sectoral rules

2.1. Banks deduct ‘holdings’ in credit and financial institutions and insurance undertakings deduct ‘participations’ in insurance, reinsurance and insurance holding companies

In the banking sector, rules provided by Article 57 from (l) to (n) of Directive 2006/48/EC are intended to avoid the double (or multiple) use of the same capital by more than one financial institution. They require that any holdings, regardless of their inclusion in the banking or trading book, in other credit and financial institutions must be deducted in order to ensure that only one institution leverages on that capital and so avoid double counting at the level of the system.

Directive 2006/48/EC fixes a level of 10% of the capital of the institution in which the instrument is held as the threshold for deduction. Holdings exceeding this threshold have to be deducted from capital. Holdings below the 10% threshold have to be deducted only if the total amount of such holdings below 10% exceeds 10% of the regulatory capital of the institution.

The issue of avoiding double counting is extended to deducting subordinated claims and hybrid instruments held in the same credit and financial institutions for which the threshold is exceeded.

33 Please refer to Annex (mapping table) for the exact wording of the elements to be deducted.

34 Competent authorities may allow institutions to treat positions covered by (l) to (n) that are holdings in the trading book as equity or debt instruments as appropriate where an institution demonstrates that it is an active market maker in these positions (cf. Annex VII, Part D, paragraph 3 of Directive 2006/49/EC).
278. Credit institutions subject to supervision on a consolidated basis or to supplementary supervision in accordance to the Financial Conglomerates Directive 2002/87/EC (FCD) need not deduct, on a stand-alone basis, holdings and other items described above held in credit institutions, which are included in the scope of their consolidated or supplementary supervision.

279. In the banking sector, in application of Article 66(2) of Directive 2006/48/EC, deductions are made half from original own funds and half from additional own funds. The transitional provision in Article 154(4) states that that participations in insurance institutions acquired before 20 July 2006 can continue, subject to national discretion, to be deducted from the sum of original own funds and additional own funds until 31 December 2012.

280. In the insurance sector, the rules designed to prevent double gearing within the insurance sector apply at the level of participations i.e. holdings of 20% or more in the shares and other capital items of other insurance, reinsurance or insurance holding companies or a “durable link” within the meaning of Article 17 of Directive 78/660/EEC.

281. As in the banking sector, the insurance sector requires the deduction of participations and also applies to subordinated claims and holdings of hybrid instruments which trigger the threshold.

282. However Articles 22.2 and 22.3 last but one paragraph of the Insurance Directives allow Member States to provide that such participations not be deducted if the insurance undertaking is subject to supplementary supervision under the Insurance Groups Directive or the Financial Conglomerates Directive. In that context, the deduction provision rarely applies.

283. In the banking and insurance sectors, at group level double gearing is eliminated for same sector holdings/participations through the consolidation methods applied in each sector (see Chapter 6) and differences identified in this section feed through into the consolidated position.

2.2. The threshold for deductions is more restrictive in the banking sector than in the insurance sector

284. While these intra-sector deductions have the same objective of preventing double or multiple gearing in both sectors, the threshold set in the banking sector of 10% or more is significantly more onerous than the 20% threshold set for the insurance sector. Although, if the 20% threshold is not met, it might still be the case that a participation may be deducted since it is material for other reasons.

285. In both sectors, such participations/holdings need not to be deducted if the insurance undertaking (respectively the credit

---

35 In the insurance sector, three methods are allowed. There is no such “group-level’ supervision” but rather a ‘supplementary’ supervision.
institution undertaking) is subject to supplementary supervision under the Insurance Groups Directive or the Financial Conglomerates Directive.

3. **Holdings/participations across sectors follow the rules introduced by amendment to the Banking and Insurance Directives by the Financial Conglomerates Directive**

3.1. The Financial Conglomerates Directive (FCD) extended the sectoral rules to avoid a cross-sectoral double counting effect

**Banking**

286. The deduction rules at cross-sectoral level are a very recent innovation in European regulation, introduced the FCD.

287. Directive 2006/48/EC has been amended as follows:

288. Participations of banks and banking groups in insurance companies\(^{36}\) are deducted from the capital of the participating institutions for the same reasons as the deductions for intra-sectoral holdings i.e. to avoid the double counting of the same capital. Article 57 of Directive 2006/48/EC requires deduction\(^{37}\) of:

\( \text{o) participations which a credit institution holds in:} \)

(i) insurance undertakings (…)

(ii) reinsurance undertakings, or

(iii) insurance holding companies;

\( \text{(p) each of the following items which the credit institution holds in respect of the entities defined in point (o) in which it holds a participation:} \)

(i) instruments referred to in Article 16(3) of Directive 73/239/EEC, and

(ii) instruments referred to in Article 27(3) of Directive 2002/83/EC;

289. Rules for cross-sectoral participations are different from the rules provided by Directive 2006/48/EC for participations held within the banking sector.

290. First of all rules for cross-sectoral participations deal only with participations and not with other holdings; the consequence of that is – when the relevant 20% threshold is not triggered and in case of no durable link - the exclusion from deduction rules of holdings within the trading book and, for banks applying IFRS/IAS of holdings within the available for sale portfolio or for which the fair value option is applied. It is understood that, in determining whether the 20%

\(^{36}\) Referred to hereafter as 'cross sectoral participations'

\(^{37}\) Please refer to Annex (mapping table) the exact wording of the elements to be deducted
threshold is triggered or not, all holdings have to be counted, including those within the trading portfolio.

291. Furthermore, the relevant threshold is 20% (instead of 10%) of the capital of the undertaking in which the interest is held. More precisely, participations are defined according to the meaning of the first sentence of Article 17 of Directive 78/660/EC ("participating interest shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company’s activities") or the ownership, direct or indirect, of 20% or more of the voting rights or capital of an undertaking.

292. In the banking sector, in application of Article 66(2) of Directive 2006/48/EC the items listed above are deducted half from original own funds and half from additional own funds. The transitional provision in Article 154(4) states that participations in insurance institutions acquired before 20.7.2006 can continue, subject to national discretion, to be deducted from the sum of Tier 1 and Tier 2 until 31.12.2012.

293. As an alternative to deduction, Member States may allow their credit institutions to apply methods 1, 2 or 3 of Annex 1 of the FCD, but method 1 (accounting consolidation) may only be applied if the competent authority is confident about the level of integrated management and internal control of the entities included in the scope of consolidation. The method chosen shall be applied in a consistent manner over time. The same rules apply in the insurance sector.

294. Credit institutions subject to supervision on a consolidated basis or to supplementary supervision in accordance with the FCD need not deduct, on a stand-alone basis, participations and other items described above held in insurance or reinsurance undertakings or insurance holding companies, which are included in the scope of consolidated or supplementary supervision.

Insurance

295. In the insurance sector exactly the same cross-sector deduction requirements as in the banking sector were introduced by the FCD by amendments to the life and non-life Insurance Directives 2002/83/EC and 73/239/EEC.

296. In the insurance sector the cross-sector deduction requirements replicate the same-sector deduction requirements and the same alternative to deduction also applies (see Articles 22.2 and 23.2 of Directive 2002/87/EC).

297. Under the supplementary supervision, Article 28(6) of Directive 2002/87/EC amended the Insurance Groups Directive (Annex 1.2.4a of Directive 98/78/EC) so that the same cross-sector participation deduction requirements that apply for solo insurance undertakings

---

38 Except for instance for the rules on liquidity, holdings outside financial sectors.
also apply for the calculation of adjusted solvency, including the same alternative methods.

3.2. The differences in thresholds for deductions may lead to regulatory arbitrage

298. The treatment of cross-sector participations is consistent in both sectors with the introduction of the FCD: the threshold is the same 20%.

299. However, two differences will potentially give rise to problems in the implementation of the FCD rules.

300. The first main difference is that banking institutions are required to deduct half from original own funds and half from additional own funds\(^{39}\) whereas in the insurance sector the deduction is from the total available solvency margin with the same consequences described under section 2.2. above.

301. The second is that while for the insurance sector the rules for intra and cross-sectoral participations are the same (i.e. the rules introduced by FCD), for the banking sector there is a difference between intra-sectoral deductions and cross-sectoral deductions.

302. If the rules applied to a financial conglomerate (FC) follow the rules provided for the sector of the head entity of the FC, the total of own funds will be different if the FC is regulated by banking or insurance rules.

303. For example, a FC headed by an insurance company need not deduct holdings in credit institutions between 10% and 20% of the capital of the credit institutions, while a FC headed by a bank needs to deduct such holdings.

304. If the rules applied to an FC follow the rules provided for the sector of each component of the FC (i.e. banking rules for banks and insurance rules for insurers), there will be inconsistencies within the same FC with incentives to allocate participations to some components of the FC rather than others.

305. In those cases, differences between banking and insurance rules could create incentives for defining the structure of financial conglomerates in order to take advantage of the arbitrage between different sectoral rules.

306. Only where there is a deficit of own funds at the conglomerate level does the FCD achieve consistency in this area by requiring the application of the most onerous sector’s rules to both sectors within a conglomerate (see Annex 1.1.2(ii) of the FCD).

307. This will be further investigated in subsequent part of the work on conglomerates.

\(^{39}\) With a transitional period until 2012.
308. The table below summarises the differences between the two sectors:

<table>
<thead>
<tr>
<th></th>
<th>Holdings in credit institutions</th>
<th>Participations in insurance undertakings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Insurance group</strong></td>
<td>Deduction if &gt; 20% or, if lesser, in case of strict link</td>
<td>Deduction if &gt; 20% or, if lesser, in case of strict link</td>
</tr>
<tr>
<td><strong>Banking group</strong></td>
<td>Deduction if &gt;10% or, if lesser, the total amount exceeding 10% of own funds</td>
<td>Deduction if &gt; 20% or, if lesser, in case of strict link</td>
</tr>
<tr>
<td><strong>Conglomerate with insurer as head of the group</strong></td>
<td>The same rule for Insurance Group (i.e. &gt;20%) or a mixture of the sectoral rules of each intermediate parent bank/insurance undertaking within the conglomerate</td>
<td>The same rule for Insurance Group (i.e. &gt;20%) or a mixture of the sectoral rules of each intermediate parent bank/insurance undertaking within the conglomerate</td>
</tr>
<tr>
<td><strong>Conglomerate with banking group as head of the group</strong></td>
<td>The same rule for Banking Group (i.e. 10%) or a mixture of the sectoral rules of each intermediate parent bank/insurance undertaking within the conglomerate</td>
<td>The same rule for Banking Group (i.e. 20%) or a mixture of the sectoral rules of each intermediate parent bank/insurance undertaking within the conglomerate</td>
</tr>
</tbody>
</table>

4. Few types of deductions are specific to each sector

309. In the banking sector, no institution may have a qualifying holding exceeding 15% of its own funds in a single non-financial undertaking. Under Article 120(2), the total amount of an institution’s qualifying holdings in such non-financial undertakings\(^{40}\) may not exceed 60% of its own funds.

310. Moreover, in application of Article 106(1) third paragraph of Directive 2006/48/EC, all elements entirely covered by own funds may, with the agreement of the competent authorities, be excluded.

\(^{40}\) i.e. undertakings other than credit institutions, financial institutions or undertakings carrying on activities which are a direct extension of banking or which concern services ancillary to banking such as leasing, factoring, the management of unit trusts, the management of data processing services, or any other similar activity,
from the determination of exposures, provided that such own funds are not included in the institution’s regulatory capital.

311. These limits may be exceeded only in exceptional circumstances; in such cases competent authorities shall require a credit institution either to increase its own funds or to take other equivalent measures - Article 120 of Directive 2006/48/EC.

312. The other deductions specific to IRB institutions and related to securitisation transactions have already been addressed in Chapter 3 above.

313. In the banking sector, Article 61 of Directive 2006/48/EC states that the concept of own funds as defined in points (a) to (h) of Article 57 embodies a maximum of items and amounts. The use of those items and the fixing of lower ceilings and the deduction of items other than those listed in points (i) to (r) of Article 57 shall be left to the discretion of the Member States.41

314. In the non-life insurance sector (Article 16 of Directive 73/239/EEC) one sector-specific provision related to discounted technical provisions. This requires the following deduction: the difference between the undiscounted technical provisions or technical provisions before deductions as disclosed in the notes to the accounts, and the discounted or technical provisions after deduction.

41 For an overview of the use of that provision in Member States, please refer to the CEBS report.
Chapter 6. Prudential consolidation and consolidated capital elements in the two sectors

315. As stated above in paragraph 12 of the report, although they are different approaches, the objectives pursued by the supervision on a consolidated basis in banking are also pursued by the supplementary supervision of insurance undertakings.

316. A fundamental objective of the supervision of group capital adequacy common to both banking and insurance is the elimination of double or multiple gearing and intra-group creation of capital.

317. There is therefore a large degree of commonality between the banking and insurance sectors with respect to the general principles of consolidated supervision.

318. With regard to the calculation of capital requirements, there are also broad similarities between the consolidated accounts methods used in the banking and the insurance sectors— but these similarities have to be examined in detail not to be misinterpreted.

319. However detailed requirements differ between the sectors, which impact the calculation of the consolidation on particular elements of capital. The main areas of difference are the scope of consolidation and the method of calculation.

1. The scope of a banking group and an insurance group defined for regulatory purposes follow different rules

1.1. The definition of a ‘group’ for regulatory purposes

320. The main characteristic of a parent-subsidiary relationship is control.

Banking


322. The reference only includes Article 1(1) of Directive 83/349/EEC on the control based on majority rights. Article 1(2) of Directive 83/349/EEC on dominant influence does not apply; instead, the banking sector Directive leaves it up to the competent authorities to determine whether there is dominant influence and whether to consolidate those dominated entities.

323. Article 133 of Directive 2006/48/EC requires “full consolidation” of subsidiaries, but the term “full consolidation” is not
further defined. There is no reference to any specific accounting rules such as the full consolidation procedures required in IFRS 3 or in Article 17 – 31 of the Seventh Directive 1983/349/EEC (e.g. set off based on book values or identifiable values, use of uniform accounting rules within the group). Therefore, there is room for variations in the techniques used to eliminate capital ties and intra-group balances.

324. For regulatory purposes, full consolidation is required only for those subsidiaries which are credit institutions and financial institutions, as set out in Article 133(1) of Directive 2006/48/EC.

325. The scope of regulatory full consolidation is therefore limited to the banking sector and does not usually include the insurance sector or any non-financial subsidiaries such as for instance subsidiaries in manufacturing.

326. However, there is no common rule on the treatment of subsidiaries in the insurance sector and in the non-financial sector; competent authorities may decide which method shall applied as stated by Article 133(3) of Directive 2006/48/EC e.g. the equity method. This gives rise to very different national treatments which may be inconsistent with international accounting rules, such as IAS 27 which requires full consolidation regardless of the subsidiary’s sector.

327. Banking sector consolidation is required at the level of the ultimate parent in any Member State in application of Article 71 of Directive 2006/48/EC.

328. If the ultimate parent company is a financial holding company, regulatory consolidation can be performed either by the financial holding company itself (if supervised) or by the “nearest” credit institution within the group (if the financial holding company is not supervised). In the latter case, the “nearest credit institution” performs consolidation from the perspective of the financial holding company as consolidating parent. Therefore, the entity issuing consolidated financial statements for statutory accounting may be different from the entity performing regulatory consolidation, even in those cases where the regulatory and statutory accounting scope of consolidation are identical.

329. Under Article 73(2) of Directive 2006/48/EC on sub-consolidation, the national “parent company” and all its domestic and foreign subsidiaries are consolidated for regulatory purposes, even if the national parent is itself part of a larger group which itself is supervised on a consolidated basis in another Member State. This is different in the statutory accounting: when the national sub-group is included in the consolidated statements of a larger (foreign) group and the national subgroup is not headed by a listed parent, it may be exempted from presenting consolidated statements under statutory

\[42\] Being part of a ‘foreign’ group is no ground for exempting the national subgroup from consolidated supervision.
accounting rules in accordance with Article 43(1)(b) of Directive 86/635/EEC.

330. If a credit institution is part of a group subject to consolidated supervision, supervision of capital requirements on a solo-basis may be waived entirely under the conditions of Article 69 of Directive 2006/48/EC. If a Member State applies this waiver, alternative measures must be taken to ensure the satisfactory allocation of risks within the group in accordance with Article 118 of Directive 2006/48/EC.

331. Directive 2006/48/EC distinguishes subsidiaries from participations; participations must not be fully consolidated and there are some additional provisions on participations.

332. For the purpose of Directive 2006/48/EC, any participation in the meaning of Article 17, 1st sentence of the Accounting Directive 1978/660/EEC is considered as participation. Rights in capital forming a durable link are considered as participation, irrespective of the actual percentage of capital held. Furthermore, Directive 2006/48/EC extends the definition of participations to any direct or indirect share of at least 20% of either the voting rights or the capital. The references to the Accounting Directives have not been updated to similar definition in IAS 28; Member States will thus have to decide how to apply the definition for IFRS institutions.

333. For participations in credit institutions and financial institutions under joint control, Article 133(1) of Directive 2006/48/EC requires proportionate consolidation. This is usually consistent with statutory accounting (IAS 31 would allow the equity method as an alternative).

334. All other participations are excluded from the regulatory parameter of consolidation. Competent authorities may decide on the consolidation methodology (Article 133(3)), but the treatment shall not constitute inclusion of the entity in consolidated supervision (Article 133(3) last sentence).

335. This rule firstly applies to participations between e.g. 20% and 50% of the capital or voting rights in credit institutions and financial institutions.

336. Such investments in credit institutions or financial institutions can only be treated as a participation, which is usually subject to deduction from own funds. Competent authorities may use different valuation principles for the participation.

337. Furthermore, gains from transactions between the group and those entities might be subject to consolidation, but in application of Directive 2006/48/EC, assets, off balance sheet exposures and liabilities nor the own funds of the respective entity, any surplus of capital over capital requirements of the respective entity, the capital provided by other shareholders to the respective entity must not be counted at group level.

\[^{43}\text{An exemption from the deduction applies in case of financial conglomerates.}\]
338. The same rule applies to "subsidaries" which are not included in the regulatory group because they are outside the banking sector (e.g. subsidiaries in the insurance sector or in the manufacturing business). This rule leads to deviations from the statutory financial statements if subsidiaries outside the banking sector are consolidated in accounting. The main reason to exclude such subsidiaries from consolidation is to exclude them from consolidated supervision (e.g. an insurance company would have to apply Directive 2006/48/EC to its assets if it was consolidated in a banking group).

339. Furthermore, Article 120 of Directive 2006/48/EC restricts participations in non-financial entities. However, participations held in insurance companies are not restricted, but generally deducted from eligible capital (see Chapter 5).

**Insurance**

340. Article 1(d) and (e) of the Insurance Groups Directive 98/78/EC (IGD) also defines parent and subsidiary according to the consolidated accounts Directive 83/349/EEC. However the IGD specifically includes the concept of dominant influence. It also defines which entities should be taken into account when performing supplementary supervision as:

- related undertakings of the insurance undertaking;
- participating undertakings in the insurance undertaking; and
- related undertakings of a participating undertaking in the insurance undertaking.

341. 'Related undertaking' means a subsidiary or other undertaking in which a participation is held, or an undertaking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC.

342. 'Participating undertaking' means a parent or other undertaking which holds a participation in, or is linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC.

343. 'Participation' means participation within the meaning of the first sentence of Article 17 of Directive 78/660/EEC or holding directly or indirectly of 20% or more of the voting rights or capital of an undertaking.

344. For the purpose of capital adequacy, the regulatory group is composed by the insurance undertaking or insurance holding company at the top level of the group and by its participated insurance/reinsurance/financial undertakings. Moreover, Article 3.3.2 of the IGD allows insurance supervisors to exclude entities from the calculation.

---

44 see annex 1.2 of IGD and para 353 for further possible implications when using the consolidation accounts method.
345. Insurance group solvency requirements currently apply at every parent level although subgroups at the levels below the ultimate parent may be waived under Articles 9 and 10 and Annexes 1 and 2 of Directive 98/78/EC.

346. In the case of a parent insurance holding company, the group solvency requirement is calculated by the nearest supervised insurance undertaking from the perspective of the parent insurance holding.

1.2. Both sectors require inclusion of financial or insurance holding companies, but the methodologies differ in practice

347. The Banking Directive generally requires full consolidation of subsidiaries even in case of minorities. The IGD requires the inclusion in the group solvency requirements of

   a. the proportionate share of related undertakings if an aggregation methodology is used,

   b. Percentage of consolidation, if the consolidated method is used. Compliance is also sought with a general principle of transferability (see Annex 1.C.3) to the discretion of competent authorities.

348. Following the introduction of the Financial Conglomerates Directive, specific provisions have been made for the treatment of cross-sector holdings in the calculation of regulatory group capital adequacy aiming at a more consistent treatment. Nevertheless, the FCD introduced various methods to deal with cross sectoral holdings which potentially gives rise to differences in the calculation of group capital.(see Chapter 5)

349. In both sectors, a financial holding company (banking sector) or an insurance holding company have to be included in the regulatory group to prevent downstreaming of lower quality capital items as higher quality capital to regulated subsidiaries. The methodologies differ in detail.

1.3. In both sectors, the definition of group for regulatory purposes differs from that used for the purposes of statutory accounts

350. Differences between the statutory accounting and the regulatory group are not based on a common methodology in either sector and this makes them hard to compare.

351. Apart from the rules on cross-sector participations introduced by the FCD, those parts of the statutory accounting group outside the specific sector are usually excluded from the calculation of regulatory capital adequacy. Where the calculation of regulatory group capital is based on consolidated statutory accounts, adjustments may be performed to account for differences in scope. However, if consolidated accounts are performed according to IAS 27, there might be no need for adjustments.
352. None of the sectoral Directives describes whether and how adjustments have to be made.

353. In the banking sector, entities which are part of the regulatory group but excluded from the accounting group must be consolidated in any case for regulatory purposes. In the insurance sector, these entities might be consolidated in addition or another calculation method may be applied.

354. More problems arise in the opposite situation, which occurs more frequently since the scope of accounting consolidation is usually larger than the regulatory one: entities which are part of the accounting group but outside the regulatory group are not explicitly addressed by the Directives.

355. In the insurance sector, investments in entities outside the banking and insurance sectors may be included as admissible assets for solvency purposes. In the banking sector it is left to supervisors how to treat those entities; however, the treatment shall not result in inclusion of the entity in consolidated supervision. To exclude those entities from consolidated supervision, different methodologies can be used. The supervisor might use the statutory consolidated financial statements and require some form of de-consolidation or segmental accounting to exclude the entity from the regulatory group. As an alternative, the Member State might require special regulatory consolidation instead of using statutory consolidated accounts.

356. In both sectors, there are no rules for reverse acquisitions, although these are quite common in practice. In some cases, the legal acquirer of an entity might in fact come under the control of the shareholders of the acquired entity when it is issuing new shares to them. In that case, the consolidating parent under IFRS 3.21 would be the acquired entity and the legal acquirer might be the subsidiary. There is no guidance on whether those consolidated statements can be used for regulatory purposes.

357. Similarly, in both sectors, there are provisions for the exclusion of entities from the calculation of regulatory capital adequacy in certain circumstances (e.g. where they are of negligible interest or in the case of a third country holding where there are legal impediments to the transfer of necessary information – see Article 73 of Directive 2006/48/EC and Article 3 of Directive 98/78/EC. And there is scope for variations in the treatment of parts of the regulatory group located in non-EU countries.

358. A waiver from solo-supervision contingent on consolidated supervision is only available in the banking sector. This waiver is subject to Member States’ discretion and to criteria to be fulfilled in application of Article 69 of Directive 2006/48/EC. These criteria include prompt transferability of capital, the existence of the guarantee of the parent for the subsidiary’s liabilities. There is no such waiver in the insurance sector.
1.4. The treatment of Special Purpose Vehicles is similar in both sectors but different to most accounting standards

359. In the banking sector, Special Purpose Vehicles (SPVs) not specifically addressed, so they are only consolidated if they meet the definition of a subsidiary in Article 4(13)(b) of Directive 2006/48/EC. SPVs are commonly established without direct capital ties to the founder, so there is usually no shareholder relationship which would be required under Article 1(1) of Directive 83/349/EEC. Therefore, SPVs are only considered subsidiaries if, "in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence".

360. In the insurance sector, SPVs are not specifically addressed by the IGD and would only be included in the scope of consolidated supervision if they meet the definition of 'subsidiary' or 'participation' in Article 1(e) or (f) of Directive 98/78/EC.

361. Therefore, none of the sectoral Directives has explicit rules for consolidating SPVs. Both Directives refer to the accounting Directives and would only require consolidation if a parent effectively exercises dominant influence.

362. Effective dominant influence may be difficult to establish. Therefore, many Member States have introduced in their accounting standards additional elements to define a subsidiary. Notably IAS 27 lists the following elements which are not explicitly mentioned in Directive 2006/48/EC and in the IGD.

- control conveyed by potential shares (e.g. currently exercisable stock options, convertibles and the like; IAS 27.14);
- the power to govern financial and operating decision making because of a contract or statutes (IAS 27.13b). Under IAS 27, this power need not be exercised effectively – the sole potential to govern the subsidiary’s decision making is sufficient to establish a subsidiary. Article 1(2) of Directive 83/349/EEC contains a similar provision, but Directive 2006/48/EC does not refer to Article 1(2) to define the consolidated regulatory group; and
- in the case of SPVs within the meaning of SIC 12 (e.g. autopilots), deemed control resulting from certain economic ties. These are, among others, SPV’s for which a parent is the main beneficiary or carries the main residual risks similar to an owner.

363. As the ‘regulatory group’ in the banking sector and in the insurance sector is generally not identical to the statutory accounting group, it is possible for SPVs to be consolidated only in statutory accounts.

364. The banking sector has additional rules on derecognition of the risks transferred to a “Securitisation Special Purpose Entity”. These rules only apply to SPVs which meet highly specific criteria (e.g. whose investors are grouped into risk tranches; Article 4(36) and Annex IX of Directive 2006/48/EC. Unless certain derecognition
criteria are met, the transferred risks are included in the transferee’s capital requirements. This inclusion has some effects which are similar to full consolidation of an SPV. There are no similar derecognition rules in the insurance sector as such securitisations are rather rare for insurance companies.

2. The calculation methods differ

2.1. While the “consolidated financial situation” of a banking group is in general obtained from consolidated statutory accounts, the ‘consolidated situation’ of an insurance group can be obtained using three different methodologies

365. In the banking sector, Article 71 of Directive 2006/48/EC and Article 2 of Directive 2006/49/EC refer to the consolidated financial situation of the parent undertaking or financial holding company as the basis for consolidated supervision.

366. The consolidated situation might be obtained from consolidated financial statements prepared for statutory accounting. Some forms of aggregation methodologies can be used in some Member States. Indeed, Member States might establish their own consolidation procedures which can vary greatly and can include elements from “aggregation” techniques and from "accounting consolidation" techniques. Even where statutory consolidated accounts are available and used for the purpose of consolidated supervision in the banking sector, they need to be adjusted (e.g. to take account of the different parameters of the statutory accounting and regulated groups).

367. For investment firms, Article 16 of Directive 2006/49/EC provides for a waiver from consolidated supervision. In this case an alternative calculation of own funds is required.

368. In the insurance sector, the IGD provides for three alternative methods for calculating group solvency, one based on consolidated accounts, another on aggregation and a third (similar to aggregation but little used) based on requirement deduction as set out in Annex 1.3 of the IGD.

369. The IGD in its Annex 1.1. also sets out a number of general principles for the calculation of adjusted solvency and the solvency of the parent undertakings of insurance undertakings. These include proportionality, elimination of the double use of solvency margin elements and intra-group creation of capital; transferability and the treatment of certain elements specific to the insurance sector. While these principles encourage consistency, the choice of methodology and the lack of reference to recognised accounting standards\(^{45}\) have

\(^{45}\) Insurance accounting in the EU is currently harmonised under the Fourth, the Seventh and the Insurance Accounts Directives. The Directives contain a significant number of options that have been exercised differently in Member States. As a consequence, the
led to different approaches between Member States, that might lead to different results that all are however effective in eliminating double gearing.

2.2. Both sectors have rules for treating intra-group capital allocation

370. Annex I Part C3 of the IGD explicitly demands transferability for any surplus of eligible capital over the capital requirements of any group member.

371. The principle of transferability applies in the insurance sector so that capital items in related undertakings in excess of those needed to cover the requirements of that related undertaking may only contribute to group capital to the extent that assets representing them are freely transferable.

372. However, transferability is not precisely defined and the IGD does not specify to what extent this rule relates to assets (which are the means of such transfers) and to equity elements.

373. As far as transferability is required for capital elements, it follows that these capital elements must be freely distributable upstream to a parent company. From a regulatory perspective, only a surplus over capital requirements can be distributed without violating capital requirements at the solo-level; furthermore, only assets freely available to the company can be distributed. From an accounting perspective, only profits and reserves not subject to capital maintenance rules can be distributed and sufficient liquidity to actually finance the distribution is required. The principle of transferability would not cover downstream transfers as these are generally booked as an exchange of assets on the asset side and do not change capital elements. However, in cases where downstream transfers increase deductions at a solo-level (e.g. the deduction of participations), downstream transfers are also limited to the surplus of eligible capital over capital requirements. Furthermore, any allocations of capital within the group might be subject to taxation which can actually reduce transferable capital or impede actual transfers. Therefore, the principle of transferability concerns both the asset side and the equity/liability side of the balance sheet and must be evaluated under national capital maintenance and taxation rules.

374. In the banking sector, Directive 2006/48/EC does not explicitly mention a principle of transferability within the regulatory group. However, in cases of waivers from solo supervision, supervisors need to ensure satisfactory allocation of risks within the group in accordance with Article 118 of Directive 2006/48/EC. This means that eligible capital must be assigned to all consolidated group members to the extent these group members generate risks (capital current supervisory rules with regard to insurance entities in the European Union are not based on a single accounting regime.
requirements) for the group. Directive 2006/48/EC does not require a particular method of allocating capital.

375. Allocating risks (capital requirements) to members of a banking group is rather straightforward because exposures (e.g. assets) at a consolidated level can be easily traced back to individual group members. However, it is rather difficult to allocate consolidated capital to individual group members. Full consolidation assumes the group is one single entity. Capital obtained from other group members is assumed to be available to cover risks in an individual entity, but this capital does not exist at the consolidated level. Therefore, it is unclear whether to allocate capital eligible at the consolidated level in proportion to capital displayed in separate financial statements or only to the extent a group member has actually obtained funds externally. Allocation can also mean transferability because transferable capital elements could be considered allocated to the group as a whole.

376. The rules on intra-group capital allocation are quite different in both sectors. In addition, it is up to supervisors to apply them to specific circumstances.

3. The calculation of eligible capital items may be affected by the prudential consolidation

377. The factors discussed above may affect individual capital items differently.

3.1. Double counting and intra-group creation of capital are prevented

378. Regardless of the consolidation method, both sectors require elimination of investments by parent companies in subsidiaries within the regulatory group in order to avoid double counting and intra-group capital creation at the group level.

379. At the solo level, the effects of double gearing are eliminated by deducting the book value of the sectoral participation or by applying one of the methods to the cross-sectoral participation (see Chapter 5). At group level, the effects are eliminated by the consolidation or aggregation methods prescribed in the Directives.

380. When Member States may exempt credit institutions or insurance companies from deduction at the solo level if they are also supervised at a consolidated level through application of Article 60 of Directive 2006/48/EC, Article 16(2) of Directive 1973/239/EEC and Article 27(2) of Directive 2002/83/EC, the effects of double gearing will only be eliminated at the group level.

381. Investments in subsidiaries which are outside the regulatory group are not eliminated apart from cross-sectoral investments as defined by the Financial Conglomerates Directive when using the consolidated accounts method (See Chapter 5).
382. In both sectors, therefore, only externally provided capital may contribute to group capital. This is also true in the application of deduction and aggregation method, even though it requires specific adjustments. Thus although there are some differences between the sectors in the precise definition of capital (see Chapter 1), the impact of consolidation in this respect is consistent across the two sectors.

3.2. The composition of Consolidated Reserves is similar

383. In the banking sector, consolidated reserves may be obtained from consolidated financial statements. The amount depends on the consolidation methodology employed.

384. In a first consolidation, reserves from subsidiaries are part of the first consolidation difference.

385. In addition, the following items may be included in consolidated reserves by application of Article 65 of Directive 2006/48/EC; “inclusion” means addition to own funds when negative (liability side) or deduction when positive (asset side):

(a) minority interests (treated in detail below); and
(b) first consolidation difference;

• if the entity concept of consolidation is used, the difference is goodwill; if the parent company concept of consolidation is used, the difference is the proportion of hidden reserves and goodwill attributable to the parent (Article 19(1)(a) or (b) of Directive 1983/349/EEC). In a first consolidation, all accumulated profits in subsidiaries attributable to the parent are included in this item.

• A positive difference (goodwill) will thus be deducted from core own funds as it is deemed a “negative reserve”. A negative difference (badwill) is considered to be a (positive) profit reserve and will be included in own funds.

(c) translation differences;

• They result from foreign currency translations booked directly to equity under Article 39(6) of Directive 86/365/EEC (foreign exchange-differences realised in the profit and loss accounts are generally included in profit carried forward or reserves); this depends on the national accounting regime.

• Under IAS 21.39, foreign exchange-translations booked directly to equity are also available at a solo level.

(d) the equivalent of the first consolidation difference when using the equity method. The equity method usually applies to subsidiaries and participations. This is redundant for any participation within the financial sector which is to be deducted from original own funds as

46 Please refer to Annex (mapping table) for the exact and complete wording of the elements.
this deduction also covers the first consolidation difference. The scope of this deduction item is thus limited to participations outside the banking sector which are excluded from full consolidation by application of Article 133(3) of Directive 2006/48/EC.

386. Only the reserve from foreign currency translation is actually a reserve in accounting terms. The other capital items are “deemed reserves” because of their nature which is similar to accounting equity.

387. In the insurance sector there are no equivalent provisions relating to the calculation of reserves. As reserves are generally accepted as eligible capital, reserves arising from consolidation would also be eligible – but only if the consolidation methodology is applied (reserves specific to consolidation do not arise during aggregation, e.g. reserves for foreign currency translation).

388. The other kinds of “deemed reserves” in the Directive 2006/48/EC would be treated similarly in the insurance sector:

a. Minority interests: They are generally included in capital, but with limits (treated in detail below): minority interests which are generally included in the banking sector are often capped by insurance supervisors with the proportional amount of the subsidiary’s capital requirements relating to the minority. In that case, any excess capital over capital requirements relating to minorities is not eligible at group level

b. Goodwill (deemed a negative reserve by Directive 2006/48/EC) would also be deducted from eligible capital in the insurance sector as an intangible asset. Badwill would generally be included if considered a profit or a profit reserve under national GAAP applicable to insurers (IFRS 3.56 considers badwill to be a profit). However, there are no detailed provisions to badwill in the IGD

389. In contrast to the banking sector, the IGD has no rules on consolidation differences (goodwill and badwill) arising under the equity method. Therefore, such goodwill would neither be deducted nor included as eligible capital in the insurance sector.

390. Profit reserves and future profits arising in a related life assurance undertaking apply only to the life assurance sector (Article 27(2) of Directive 2002/83/EC). These may only be included in the calculation of group capital in so far as they are eligible for covering the solvency margin of that related undertaking (Annex 1.1.C2 of IGD).

391. Intra-group profits should be deleted under IGD Annex 1.C.1 and Annex 1.D.
3.3. The treatments of hybrids follow the consolidation procedures

392. In the banking sector, hybrid capital instruments issued by a consolidated credit institution enter consolidated capital via the normal consolidation procedures.

393. If issued by the consolidating parent, innovative and non-innovative capital instruments become part of consolidated capital directly.

394. If issued by a subsidiary or SPV, the issuing entity must be fully consolidated to include hybrid capital instruments in consolidated capital.

395. If the hybrid capital instrument is equity, it usually qualifies as a minority interest; if it is a liability, it is integrated through full consolidation of liabilities. In the case of an SPV, the Sydney press release requires that funds from the issue must be transferred to a (consolidated) bank through the same or higher quality capital immediately or upon a certain trigger event, but well before serious deterioration in the bank's financial position.

396. In the insurance sector, when hybrids are used to meet the local requirements in excess of the Directive minima it is up to each Member State to define whether, and if so the extent to which, they accept hybrids for the purpose of group solvency.

3.4. Whereas the treatment of minorities is strictly defined in the Banking Directives, the Insurance Directives leave room for different treatments

397. In the banking sector, minority interests result from the global integration method (which is a synonym for full consolidation) and represent capital provided by shareholders of the consolidated subsidiaries who are external to the group. Article 21 of Directive 83/349/EEC defines how minority interests are determined.

398. Minority interests are part of eligible capital at a consolidated level as stated by Article 65(1)(a) of Directive 2006/48/EC.

399. When to apply full consolidation for regulatory purposes is not a question of financial accounting and the accounting Directives, but a question of the regulatory consolidation requirements. Therefore, only minority interests in subsidiaries within the regulatory group are eligible; subsidiaries and any other participations that are excluded from full consolidation under Article 133 of Directive 2006/48/EC (e.g. subsidiaries in the insurance sector or manufacturing businesses) cannot give rise to minority interests eligible for the regulatory group’s capital.

400. Minority interests are valued at the minorities’ share of the subsidiaries equity; hidden reserves in the subsidiary’s assets at the
time of first consolidation are commonly included in minority interests in the context of Article 19(1)(b) of Directive 83/349/EEC, especially when applying IAS 27.

401. In the insurance sector, there are different treatments of minority interests in the IGD.

402. The principles of proportional share and transferability apply: any capital elements in related undertakings in excess of those used to cover requirements in that related undertaking may only be taken into group capital in relation to the group's proportional share in the related undertaking - except for a solvency deficit which should be counted in full.

403. However, the principle of proportional share is again dependent on the consolidation methodology; if consolidated accounts are used, the “proportional share” is the one used in accounting (see Appendix I Part 1 B of Directive 98/78/EC). This means that in the case of fully consolidated subsidiaries, the proportional share in accounting is 100% irrespective of the actual participation.

404. When the consolidation method is used, the control concept used in accounting combined with the principles of transferability and proportional share in the IGD, will lead to the limitation of minority interests.

405. To fulfill the concept of proportionality in the insurance sector, inclusion of minorities in consolidated capital is usually limited to the minority’s share of capital requirements, i.e. a net capital surplus over the capital requirements is not usually accepted in the insurance sector. This approach in practice ensures the consistency between the method of ‘consolidation’ and the ‘deduction/aggregation’ method.

406. There is no principle of proportionality or principle of transferability in the banking sector. Minority interests are usually not capped by the minority’s share in the subsidiaries’ capital requirements, so any excess over capital requirements is eligible at group level.

407. Whereas minority interests are limited to subsidiaries of the regulatory group in the banking sector, there are no clear limitations in the insurance sector as the Insurance Directives do not directly address minorities. Minority interests might conceivably arise from subsidiaries outside the insurance sector or even outside the financial sector.

408. Whereas in the banking sector, minority interests are valued based on the accounting concepts laid down in the Seventh Company Law Directive, there are no rules on valuation of minorities in the insurance sector.
Chapter 7. IAS/IFRS implications – the use of prudential filters in the two sectors

409. Following the introduction of IAS/IFRS accounting rules, CEIOPS and CEBS have issued guidelines to avoid that the new accounting regime weakens the prudential regulation and to maintain the definition – and quality – of regulatory capital or available solvency margin of, respectively, financial institutions and insurance companies, in the same state as before the introduction of IAS/IFRS accounting rules.

410. Article 64(4) of Directive 2006/48/EC has defined two mandatory prudential filters for institutions. Exception made of these two which are mandatory, prudential filters are optional and as a consequence may be used differently by Member States.

411. It should be noted that CEIOPS is working on valuation standards for prudential purposes relating to assets and technical provisions in the framework of the Solvency II project. These valuations standards are generally more in line with IFRS rules, meaning that the need of prudential filters may decrease in the future.

1. Filters apply to elements eligible without limits in both sectors

1.1. Both CEBS and CEIOPS have recommended similar filters on equity, (Statutory) reserves and profit

Filters relating to Equity

412. Some instruments classified as equity under the accounting Directives will be classified as liabilities under IAS 32. Shares in cooperative entities (such as some mutual insurance undertakings) and certain preferred shares are likely to be affected.

413. On the other hand some liabilities with embedded derivatives that are not classified as equity today may contain equity-type embedded derivatives which will be automatically classified as equity under IAS. This would, for example, relate to the conversion option in a convertible bond.

414. Both CEBS and CEIOPS recommend continuing the current treatment of equity and liability components. This filter applies not only to instruments eligible as capital but also other instruments (for example, preferential shares or perpetual subordinated debt) included in regulatory own funds or solvency margin.
Filters relating to (statutory) reserves and profit

415. **Cash flow hedges reserves**: for the banking sector, Article 64(4) of Directive 2006/48/EC excludes fair value reserves related to cash flow hedges of financial instruments measured at amortized cost. CEIOPS has issued a similar recommendation for the insurance sector.

416. **Own credit risk on liabilities valued at fair value**: for the banking sector, Article 64(4) of Directive 2006/48/EC excludes any cumulative unrealised gains and losses arising from changes in an institution’s own credit standing as a result of the valuation of liabilities at fair value. CEIOPS has issued a similar recommendation for the insurance sector.

1.2. With regard to the following items, filters apply in the two sectors differently

**Unrealised gains and losses on investment properties and unrealised losses on own use properties valued under the fair value model**

417. For these unrealised gains and losses in the banking sector, CEBS proposes to deduct cumulative unrealised losses from original own funds and to include partially in additional own funds cumulative unrealised gains. In the context of prudential filters, partially means that at least the tax effect should be taken into account.

418. In general there is no need for regulatory adjustments in cases where the cost method is applied. However, national competent authorities are encouraged to consider the need for transferring unrealised gains, if any, resulting from the first application of the cost method to properties from original own funds to additional own funds.

419. For these unrealised gains and losses in the insurance sector, CEIOPS suggests that the supervisor may neutralize the effect of IAS 40/IAS 16 through national adjustment, provided that these are in line with the EU Directives, and consequently maintain the current valuation criteria. This means that for countries whose system is based on historic cost principles, unrealised gains are considered as an eligible element only under certain circumstances and with prior approval of the supervisor. For countries whose system is based on the market value principle, unrealised gains may continue to be totally or partially recognised in regulatory capital even if the insurance company adopts the cost model of IAS 40/IAS 16 and considering the establishment of prudential requirements regarding valuers and valuations. There is no CEIOPS recommendation specific to unrealised losses.

**Revaluation reserve on available for sale financial assets**

420. CEBS proposes that for fair value revaluation reserves on available for sale assets the following prudential filters should apply:
• for **equities**, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax.

• for **loans and receivables**, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax.

• for **other available for sale assets**, (for example debt securities, financial instruments subject to interest rate risk) two methods can be applied. According to the first one, items classified in this portfolio should be treated as equities; under the second method, they should be treated as loans and receivables. On a related issue, CEBS considers that there should be consistent treatment of gains and losses resulting from a transaction whereby a cash flow hedge is created for an available for sale instrument: i.e. if the gains on the hedged item are recognized in additional own funds, so should the results of the corresponding cash flow hedging derivative.

421. As a general principle, no regulatory adjustments should be made to impairment losses. Impairment related to credit risks should always be taken into account via the profit and loss account and therefore deducted from original own funds. Any additional supervisory formal recommendation or requirement regarding credit risk impairment should also be deducted from original own funds.

422. In the context of prudential filters partially means that at least the tax effect should be taken into account.

423. With regard to revaluation reserves on available for sale financial assets in the insurance sector, CEIOPS recommends relying on the maintenance of the current valuation criteria. This means that for jurisdictions using “historical cost” criteria, they may need to require that unrealised gains and losses on available for sale assets have the characteristics foreseen by the national solvency regime.

**Valuation of financial assets measured at fair value though the income statement**

424. For insurance companies, CEIOPS proposes to keep the existing valuation rules for countries applying the historical cost method. Keeping the existing evaluation methods could imply not admitting unrealised gains.

425. The only filters applicable for the banking sector relate to the use of the fair value option. The banking supervisor may adjust own funds if the fair value is not sufficiently reliable or the use of the fair value option is not adequate. The supervisor may base its assessment on the “supervisory guidance on the use of the fair value option for financial instruments by banks” published by the Basel Committee in June 2006.

**Valuation of pension commitments (IAS 19)**

426. For the insurance sector, CEIOPS recommends that supervisors pay attention that a net asset resulting from the valuation of pension assets and liabilities is deducted from the available solvency margin to the extent that it does not entitle to a reimbursement from the
pension regime or to a reduction of future contributions. In any case, supervisors should consider the need for any transitional arrangements at the time of the initial adoption of the standard.

427. For the banking sector, CEBS recommends that for pension costs, stock option costs and leasing no regulatory capital adjustments should be applied to regulatory capital and accordingly the adoption of IFRS will impact on profit and loss. However, consideration should be given to the need for any transitional/other arrangements at the time of the initial adoption of the standards, or to accommodate particular national circumstances relating to these items.

1.3. Filters specific to insurance groups have been developed.

428. **Equalisation provisions**: This filter is specific to the insurance sector. Taking into account the current prudential framework, CEIOPS recommends that amounts (relating to equalization and catastrophic provisions which are for accounting purposes included in equity) should not be taken into account as an eligible element in the calculation of available solvency capital. Equalisation reserves other than those required by Prudential Directives should be allowed as eligible elements on an individual basis.

429. **Discretionary participation features**: under the European Accounting Directives, bonuses intended for policyholders but not yet credited to individual policyholders should be accounted for as liabilities or, as an alternative, as an item in the balance sheet neither belonging to liabilities nor to equity. Under IFRS 4 it is not permitted to show an item between equity and liabilities. Unallocated surpluses should either be accounted for as part of equity or as a liability or split into liability and equity components. CEIOPS recommends that Member States maintain the current national regime, by reallocating amounts from equity to liabilities, to the extent to which they are assessed to be allocated to policyholders as bonuses in the future. This filter is specific to the insurance sector. As indicated above, those parts of the participation fund surplus which have been already assigned to individual contracts do not count as eligible capital.

430. **Valuation of subsidiaries**: IAS 27 requires the use of the cost method or, under certain circumstances, the use of the fair value method in the separate accounts of an entity. In the consolidated statement the equity method is preferred. For countries whose current system is not based on the cost method, CEIOPS proposes to keep the current method for solvency purposes, i.e. to apply the equity method in the separate accounts as well. CEBS has not defined specific filters for this item.
2. There are no specific filters relating to elements eligible with limits

431. The only filters applicable are the filter relating to the definition of debt/equity and, for the banking sector, the filters relating to the unrealised gains on investments properties, own use properties and AFS assets which may be included partially in additional own funds.

3. Filters relating to intangible assets

432. For intangible assets, CEIOPS has not defined a filter for the insurance sector. The possible increase in the amount of intangible assets has, according to CEIOPS, no specific prudential implication since intangible assets are deducted from the available solvency margin. Thus no filters are necessary and supervisors may continue to deduct all the new intangible assets from the eligible elements.

433. For the banking sector, CEBS recommends that for existing intangible assets, including goodwill, the current regulatory capital treatment should continue, meaning that CEBS accepts that new intangible assets under IAS 38 may be not deducted from own funds.

4. Filters have been developed to address the sectoral specifics of banking and insurance activities

Filters specific to the insurance sector

4.1 Definition of insurance contract

434. The ineligibility of certain contracts to be considered as insurance contracts according to IFRS 4 may have effects on the level of technical provisions and required solvency margin. CEIOPS proposes to keep the existing definition of insurance contracts for supervisory purposes.

4.2 Valuation of insurance liabilities

435. Since the minimum margin required is based to a certain extent on the amount of technical provisions (especially in life business classes), the option for insurers to change their accounting criteria in this field has an impact for supervisory purposes. CEIOPS proposes to keep the existing evaluation methods for solvency purposes.

Filters specific to the banking sector

4.3 Scope and method of consolidation

436. CEBS recommends that securitisation transactions fulfilling the criteria in the Directives should follow the revised prudential framework regardless of the accounting treatment.

4.4 Regulatory definition of trading book

437. IFRS may change the current prudential classification of financial instruments and have consequences for the boundary between trading and banking books, even if this has no impact on the
amount of own funds. CEBS considers that the reclassification of items should not be carried through to prudential regulation and proposes accordingly to keep the current prudential definition of the trading portfolio. This filter relates mainly to the capital requirement but also to the calculation of the trading book profit which can be taken into account in own funds.

4.5 Value of the exposure for the calculation of Risk Weighted Assets

438. In order to mirror the impact of prudential filters on own funds, CEBS recommends that national competent authorities should require some adjustments to the balance sheet value of the exposures used in the computation of an institution’s risk weighted exposures based on accounting numbers.
### Mapping of eligible capital elements in the insurance and in the banking sectors

<table>
<thead>
<tr>
<th>Ref. to Directives</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Denomination</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Item(a) of Art 57</td>
<td>capital within the definition of Art. 22 of Dir. 86/635/EEC in so far as it has been paid up</td>
<td>Art. 27 2. (a) of the Recast Life Dir. 2002/83/EC and Art. 16(2) of Dir. 73/239/EEC as amended</td>
<td>Paid-up share capital</td>
</tr>
<tr>
<td>of Dir. 2006/48/EC</td>
<td>plus share premium accounts</td>
<td>No reference</td>
<td></td>
</tr>
<tr>
<td></td>
<td>excluding cumulative preferential shares.</td>
<td>See below</td>
<td></td>
</tr>
<tr>
<td>No reference</td>
<td>Specific to mutual sector - no equivalent in the banking sector</td>
<td>Article 27 2. (a) of the Recast Life Dir. 2002/83/EC and Article 16 2.(a) of Dir. 73/239/EEC as amended</td>
<td>plus initial or foundation fund</td>
</tr>
<tr>
<td>No reference</td>
<td>Specific to mutual sector - no equivalent in the banking sector</td>
<td></td>
<td>plus Members’ accounts</td>
</tr>
<tr>
<td><strong>Reserves</strong></td>
<td>Reserves within the definition of Art. 23 of Dir. 86/635/EEC in connection with Art. 9 of Dir. 78/660/EEC under Liabilities item A.IV.</td>
<td>Consolidated reserves may be obtained from consolidated financial statements (see above discussion for consolidated issued capital). Amount depends on consolidation methodology employed. In first consolidation, reserves from subsidiaries are part of first consolidation difference (see below). In addition, the following items may be included in consolidated reserves (Art 65 of Dir. 2006/48): “inclusion” means addition to own funds when negative (liability side) or deduction when positive (asset side): (a) minority interests; minority interests result from the global integration method (full consolidation) and represent capital provided by shareholders of the consolidated subsidiaries external to the group. Interests need not be a “minority” in terms of voting power since MS may use global integration for non-subsidiaries as well (Art. 133(3) and Art. 134 of Dir. 2006/48).</td>
<td>Reserves</td>
</tr>
<tr>
<td>Item(b) of Art. 57</td>
<td></td>
<td>Article 27 2. (b) of the Recast Life Dir. 2002/83/EC and Article 16 2.(b) of Dir. 73/239/EEC as amended</td>
<td></td>
</tr>
<tr>
<td>of Dir. 2006/48/EC</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Mapping of eligible capital elements in the insurance and in the banking sectors

<table>
<thead>
<tr>
<th>Bank</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ref. to Directives</strong></td>
<td><strong>Denomination</strong></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) first consolidation difference; if the entity concept of consolidation is used, the difference is goodwill; if the parent company concept of consolidation is used, the difference is the proportion of hidden reserves and goodwill attributable to the parent (Art. 19 para 1 (a) or (b) of Dir. 1983/349). In first consolidation, all accumulated profits in subsidiaries attributable to the parent are included in this item.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(c) translation differences; these result from foreign currency translation booked directly to equity under Art. 39(6) of Dir. 86/365 (FX-differences realised in 1986 are generally included in profit carried forward or reserves); depends on national accounting regime. Under IAS 21.39, FX-translation booked directly to equity is also available at solo-level (no guidance - may be &quot;other reserves&quot;).</td>
</tr>
<tr>
<td></td>
<td>(d) the equivalent to the first consolidation difference (item a) when using the equity method. This is redundant for any participation within the financial sector which is to be deducted from core own funds. The equity method usually applies to associates; alternatively, MS may elect proportionate consolidation to avoid deduction of participation (Art. 133(3) Dir. 2006/48).</td>
</tr>
<tr>
<td>and profits and losses brought forward as a result of the application of the final profit or loss.</td>
<td>Article 27 2.(c) of the Recast Life Directive 2002/83/EC and Article 16 2.(c) of Directive 73/239/EEC as amended</td>
</tr>
<tr>
<td>Second last para of Art. 57</td>
<td>interims</td>
</tr>
<tr>
<td>Last para of Art. 57</td>
<td>less net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisations.</td>
</tr>
<tr>
<td></td>
<td>Bank</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>------------------------------------------------</td>
</tr>
<tr>
<td><strong>Profit reserves</strong></td>
<td>No reference</td>
</tr>
<tr>
<td></td>
<td>Specific to the life insurance sector - No</td>
</tr>
<tr>
<td></td>
<td>equivalent in the banking sector</td>
</tr>
<tr>
<td>**Funds for general banking</td>
<td>Item (c) of Art. 57 of Dir. 2006/48/EC</td>
</tr>
<tr>
<td>risks**</td>
<td>Funds for general banking risks within the</td>
</tr>
<tr>
<td></td>
<td>definition of Article 38 of Directive 86/635/EEC</td>
</tr>
<tr>
<td></td>
<td>No reference</td>
</tr>
<tr>
<td><strong>Hybrid instruments</strong></td>
<td>No reference</td>
</tr>
<tr>
<td></td>
<td>Hybrid instruments</td>
</tr>
<tr>
<td></td>
<td>Hybrid instruments taken into consideration to</td>
</tr>
<tr>
<td></td>
<td>cover capital requirements, subject to limits</td>
</tr>
<tr>
<td></td>
<td>defined at national discretion</td>
</tr>
<tr>
<td></td>
<td>No reference</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Own shares</strong></td>
<td>Items (i) of Art 57 of Dir. 2006/48/EC</td>
</tr>
<tr>
<td></td>
<td>Own shares at book value, held by the credit</td>
</tr>
<tr>
<td></td>
<td>institution</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Intangible assets</strong></td>
<td>Item (j) of Art 57 of Dir. 2006/48/EC</td>
</tr>
<tr>
<td></td>
<td>Intangible assets within the definition of Art.</td>
</tr>
<tr>
<td></td>
<td>4(9) of Dir. 86/635/EEC referring to headings</td>
</tr>
<tr>
<td></td>
<td>B and C. I of Art. 9 of Dir. 78/660/EEC</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>**Material losses of the</td>
<td>Item (k) of Art 57 of Dir. 2006/48/EC</td>
</tr>
<tr>
<td>current financial year.</td>
<td>Material losses from the current financial</td>
</tr>
<tr>
<td></td>
<td>year.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>No reference</td>
</tr>
<tr>
<td>**Adjustments for discounting</td>
<td>No reference</td>
</tr>
<tr>
<td>of non-life technical provisions</td>
<td>Specific to the non-life insurance sector- No</td>
</tr>
<tr>
<td></td>
<td>equivalent in the banking sector</td>
</tr>
</tbody>
</table>
## Mapping of eligible capital elements in the insurance and in the banking sectors

<table>
<thead>
<tr>
<th>Ref. to Directives</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Denomination</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank</strong></td>
<td></td>
<td><strong>Insurance</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Additional own funds - included up to 100% of original own funds</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revaluation reserves</td>
<td>Item (d) of Art. 57 of the Dir. 2006/48/EC</td>
<td>Revaluation reserves within the meaning of Art 33 of Dir. 78/660/EEC;</td>
<td>No reference</td>
</tr>
<tr>
<td>Adjustments due to the revaluation effects introduced by the application of IAS/IFRS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value adjustments</td>
<td>Item (e) of Art. 57 of the Dir. 2006/48/EC</td>
<td>Value adjustments within the meaning of Art. 37(2) of Dir. 86/635/EEC</td>
<td>No reference</td>
</tr>
<tr>
<td>Art 63(3) of Dir.2006/48/EEC</td>
<td></td>
<td></td>
<td>No reference</td>
</tr>
<tr>
<td></td>
<td>Art 27 3. (b) of the Recast Life Dir. 2002/83/EC and Art. 16 3.(b) of Dir. 73/239/EEC as amended</td>
<td>Securities with no specified maturity date</td>
<td></td>
</tr>
<tr>
<td>Any positive difference between value adjustments and provisions and expected loss for institutions using the IRB approach. In case of a negative difference, the negative difference is deducted half from original own funds and half from additional own funds in accordance with Art.57(q). (See below)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Items covering normal banking risks</td>
<td>Item (f) of Art. 57 of the Dir. 2006/48/EC</td>
<td>Other items within the meaning Art. 63 (1) Dir. 2006/48;</td>
<td>No reference</td>
</tr>
<tr>
<td>Securities of indeterminate duration/perpetual</td>
<td>Item (f) of Art. 57 of Dir. 2006/48/EC</td>
<td>Securities of indeterminate duration that fulfill all the conditions laid down in Art 63 (2) Dir. 2006/48;</td>
<td>Article 27 3. (b) of the Recast Life Dir. 2002/83/EC and Art. 16 3.(b) of Dir. 73/239/EEC as amended</td>
</tr>
<tr>
<td>Other instruments</td>
<td>Item (f) of Art. 57 of Dir. 2006/48/EC</td>
<td>Other instruments that fulfill the conditions laid down in Art 63 (2) Dir. 2006/48/EC;</td>
<td>Other instruments, including cumulative preferential shares other than those mentioned in Dir 2002/83/EC Article 27 3. (a) and Art. 16 3.(a) of Dir. 73/239/EEC as amended</td>
</tr>
</tbody>
</table>
## Mapping of eligible capital elements in the insurance and in the banking sectors

<table>
<thead>
<tr>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perpetual subordinated loan capital</td>
<td>Item (f) of Art. 57 of Dir. 2006/48/EC</td>
<td>Other instruments that fulfill all the conditions set out in Article 63(2) and others than those mentioned in Art 57(h) of Dir.2006/48/EC</td>
<td>Article 27 3. (a) of the Recast Life Dir. 2002/83/EC and Art. 16 3.(a) of Dir. 73/239/EEC as amended</td>
</tr>
<tr>
<td>Cumulative preference shares</td>
<td>Last paragraph of Art 63(2)</td>
<td>Cumulative preferential shares other than those referred to in Art 57(h) of Dir.2006/48/EC</td>
<td>Article 27 3. (a) of the Recast Life Dir. 2002/83/EC and Art. 16 3.(a) of Dir. 73/239/EEC as amended</td>
</tr>
<tr>
<td>Hybrid instruments</td>
<td>No reference</td>
<td>Hybrid instruments</td>
<td>No reference</td>
</tr>
<tr>
<td>Commitments specific to coop. societies</td>
<td>Item (g) of Art. 57 of Dir. 2006/48/EC</td>
<td>Commitments of the members of credit institutions set up as co-operative societies.</td>
<td>No reference</td>
</tr>
<tr>
<td>Fixed-term cumulative preferential shares</td>
<td>Item (h) of Art. 57 of Dir. 2006/48/EC</td>
<td>Fixed-term cumulative preferential shares referred to in Art 57(h)</td>
<td>Article 27 3. (a) of the Recast Life Dir. 2002/83/EC and Article 16 3. (a) of Dir. 73/239/EEC as amended</td>
</tr>
<tr>
<td>Subordinated loan capital</td>
<td>Item (h) of Art. 57 of Dir. 2006/48/EC</td>
<td>Subordinated loan capital</td>
<td>Item (h) of Art. 57 of Dir. 2006/48/EC</td>
</tr>
</tbody>
</table>
### Deductions from total own funds - half from original own funds, half from additional own funds

#### Holdings in credit and financial institutions, including subordinated claims and instruments

<table>
<thead>
<tr>
<th>Ref. to Directives</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Denomination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item (l) of Art. 57 of Dir. 2006/48/EC, Dir. 2006/48/EC, Art. 58 and 60 of Dir. 2006/48/EC, annex VII, Part D, para. 3 of Dir.</td>
<td>Holdings in other credit and financial institutions amounting to more than 10% of their capital</td>
<td>Art. 22 2 (a) and 23 2 (a) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC</td>
<td>Participations in credit institutions and financial institutions within the meaning of Art 1 (1) and (5) Dir 2000/12/EC (Art 4(1b,5) Dir 2006/48/EC) and investment firms and financial institutions within the meaning of Art 1 (2) Dir 93/22/EEC (Art 4(1,1) Dir 2004/39/EC) and Art 2 (2) and (7) of Dir 93/6/EEC (Art 31(b) &amp; 32) Dir 2006/49/EC.</td>
</tr>
<tr>
<td>Item (m) of Art. 57 of Dir. 2006/48/EC, Art. 58, 60 of Dir. 2006/48/EC, annex VII, Part D, para. 3 of Dir.</td>
<td>Subordinated claims and instruments referred to in Art 63 and 64(3) of Dir. 2006/48/EC which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10% of the capital</td>
<td>Art. 22 2 (b) and 23 2 (b) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC.</td>
<td>Each of the following items which the insurance undertaking holds in respect of the entities defined in (a) in which it holds a participation: - subordinated claims and instruments referred to in Art 35 and 36 (3) Dir 2000/12/EC (Art 63 and 64(3)) Dir 2006/48/EC.</td>
</tr>
<tr>
<td>Item (n) of Art. 57 of Dir. 2006/48/EC, Art. 58 and 60 of Dir. 2006/48/EC, annex VII, Part D, para. 3 of Dir.</td>
<td>Holdings in other credit and financial institutions of up to 10% of their capital, the subordinated claims and the instruments referred to in Art.63 and 64(3) which a credit institution holds in respect of credit and financial institutions other than thoses referred to in (l) and (m) in respect of the amount of the total of such holdings, subordinated claims and instrument which exceed 10% of that credit institution's own funds calculated before the deduction of items in (l) and (p)</td>
<td>Art. 22 2 (b) and 23 2 (b) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC.</td>
<td>Each of the following items which the insurance undertaking holds in respect of the entities defined in (a) in which it holds a participation: - subordinated claims and instruments referred to in Art 35 and 36 (3) Dir 2000/12/EC (Art 63 and 64(3)) Dir 2006/48/EC.</td>
</tr>
</tbody>
</table>

#### Participations in insurance, reinsurance undertakings and insurance holding companies

<table>
<thead>
<tr>
<th>Ref. to Directives</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Denomination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item (o) of Art. 57 of Dir. 2006/48/EC, Art 58, 59, 60 of Dir. 2006/48/EC</td>
<td>participations within the meaning of Art 4(10) which a credit institution holds in: (i) insurance undertakings within the meaning of Art 6 of Dir. 73/239/EEC, Art 4 of Dir. 2002/83/EC or Art 1(d) of Dir. 98/78/EC, (ii) reinsurance undertakings within the meaning of Art 1(c ) of Dir. 98/78/EC, or (iii) insurance holding companies within the meaning of Art. 1(i) of Dir. 98/78/EC</td>
<td>Art. 22 2 (a) and 23 2 (a) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC</td>
<td>Participations which the insurance undertaking holds in (i) insurance undertakings within the meaning of of Art 6 Dir 73/239/EEC, Art 6 of First Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions related to taking up and pursuit of business of direct life assurance (Art 1(a) &amp; 4 of Dir 2002/83/EC) or Art 1 (b) Dir 98/78/EC, (ii) reinsurance undertakings within the meaning of Art 1(c) of Dir 98/78/EC and (iii) insurance holding companies within the meaning of Art 1(i) of Dir 98/78/EC.</td>
</tr>
<tr>
<td>Item (p) of Art. 57 of Dir. 2006/48/EC, Art 58, 59, 60 of Dir. 2006/48/EC</td>
<td>each of the following items which the credit institution holds in respect of the entities defined in point (p) in which it holds a participation : (i) instruments referred to in Art. 16(3) of Dir. 73/239/EEC, (ii) instruments referred to in Art 27(3) of Dir. 2002/83/EC.</td>
<td>Art. 22 2 (b) and 23 2 (b) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC.</td>
<td>Each of the following items which the insurance undertaking holds in respect of entities defined in Art. 22 2 (a) and 23 2 (a) of Dir. 2002/87/EC amending Dir. 73/239/EEC and 79/267/EEC in which it holds a participation: - instruments referred to in Art 27(3) of Dir. 2002/83/EC.</td>
</tr>
</tbody>
</table>
### Annex IWCFC-DOC-07/01

#### Mapping of eligible capital elements in the insurance and in the banking sectors

<table>
<thead>
<tr>
<th>Ref. to Directives</th>
<th>Bank</th>
<th>Denomination</th>
<th>Ref. to Directives</th>
<th>Insurance</th>
<th>Denomination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative amounts arising from the calculation of EL for IRB institutions</td>
<td>Item (q) of Art. 57 of Dir. 2006/48/EC</td>
<td>for credit institutions calculating risk weighted exposure amounts under Section 3, subsection 2 (IRB method), negative amounts resulting from the calculation in Annex VII, Part 1, point 36 and expected loss amounts calculated in accordance with Annex VII, Part 1, points 32 and 33</td>
<td>No reference</td>
<td>Specific to the banking sector</td>
<td></td>
</tr>
<tr>
<td>Exposure amount of 1250%-risk weighted securitisation amounts</td>
<td>Item (r) of Art. 57 of Dir. 2006/48/EC</td>
<td>the exposure amount of securitisation positions which receive a risk weight of 1250% under Annex IX, Part 4, of Dir. 2006/48/EC calculated in the manner there specified</td>
<td>No reference</td>
<td>Specific to the banking sector</td>
<td></td>
</tr>
<tr>
<td>Free deliveries from 5 business days post second contractual payment or delivery leg until extinction of the transaction</td>
<td>Annex II, Directive 2006/49/EC, Table 2</td>
<td>deduct the value transferred plus current positive exposure from own funds when dealing with free deliveries from 5 business days post second contractual payment or delivery leg until extinction of the transaction</td>
<td>No reference</td>
<td>Specific to the banking sector</td>
<td></td>
</tr>
</tbody>
</table>

(*) To the extent that half of their total exceeds the total of additional own funds, the excess shall be deducted from the total of original own funds.

<table>
<thead>
<tr>
<th>Ancillary Own Funds - MAX. 150% or 250% of original own funds left to meet the market risk requirements</th>
<th>Elements that need prior approval of the supervisory authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Art 13 (1): own funds of investment firms and credit institutions are determined in accordance with the provisions of Directive 20006/48/EEC. However, art 13(2): by derogation, competent authorities may permit institutions which needs to meet capital requirements for market risks to use an alternative definition of own funds</td>
<td>Article 27 4. (d) of the Recast Life Directive 2002/83/EC and Article 16 4. (a) of Directive 73/239/EEC as amended</td>
</tr>
<tr>
<td>Own funds</td>
<td>Unpaid share capital</td>
</tr>
<tr>
<td>Art 13 (2)(a) of Dir. 2006/49/EC</td>
<td>Own funds defined in Dir. 2006/48/EC, excluding only item (i) to (p) of Art 57 for those investment firms which are required to deduct item (d) of this para from the total (a) to (c)</td>
</tr>
<tr>
<td>Net trading book profits</td>
<td>Unpaid initial fund</td>
</tr>
<tr>
<td>Art 13 (2)(b) of Dir. 2006/49/EC</td>
<td>Net trading book profits net of any foreseeable charges or dividends, less net losses on its other business</td>
</tr>
<tr>
<td>Article 13 (2)(c) of Dir. 2006/49/EC</td>
<td>Hidden net reserves arising out of the valuation of assets</td>
</tr>
<tr>
<td>Bank</td>
<td>Denomination</td>
</tr>
<tr>
<td>------</td>
<td>--------------</td>
</tr>
<tr>
<td>Subordinated loan capital</td>
<td>Subordinated loan capital and/or the items referred to in para 5 of this article (Art 13), subject to conditions set out in the paragraphs 3 and 4 of the Article and in Article 14</td>
</tr>
<tr>
<td>Members calls</td>
<td>No reference</td>
</tr>
<tr>
<td>Illiquid assets.</td>
<td>Less illiquid assets as specified in Art.15</td>
</tr>
<tr>
<td>Future profits</td>
<td>Specific to the insurance sector</td>
</tr>
<tr>
<td>Zillmerising amounts</td>
<td>Specific to the insurance sector- No equivalent in the banking sector</td>
</tr>
</tbody>
</table>