Interim Working Committee on Financial Conglomerates	IWCFC/DOC/08/03

Recommendations to address the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates

7 April 2008

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Executive summary

1. In response to Parts A and B of the European Commission's Call for Advice (CfA) to the IWCFC of 21 June 2007 on 'Sectoral rules on eligible capital and analysis of the consequences for supervision of financial conglomerates' reports on a comparison of the respective sectoral rules and an assessment of the impact of the differences in the sectoral rules on the calculation of own funds of financial conglomerates have been published on the CEBS and CEIOPS websites[1].

2. According to the comparison of the sectoral rules two types of differences were identified: differences related to the nature of the business of each sector (treatment of unrealised gains and revaluation reserves, sector-specific capital components such as profit reserves for life insurers) and differences unrelated to any business specificities and thus prone to regulatory arbitrage (e.g. calculation method at group level, intra-sector deductions, reference points for deductions, definition/application of prudential filters). Different approaches were also identified regarding the treatment of hybrid capital instruments.

3. On the basis of these findings the IWCFC flagged four main differences that should be addressed: the treatment of hybrids and the limits applied to subordinated loans and hybrids, the different approaches to deductions, the treatment of unrealized profits and revaluation reserves and the differences in consolidation approaches and methods.

4. Based on its previous reports that have been delivered to the Commission, the IWCFC has drafted recommendations to address the sectoral differences between sectoral rules on own funds for conglomerates.[2] Among the purposes of the recommendations are the enhancement of the level playing field within financial conglomerates and between financial conglomerates and "pure" banking or insurance groups and the avoidance of undue burdens for conglomerates stemming for example from the application of different calculation methods for the banking and insurance parts of the conglomerate.

5. The analysis focused on the four main differences that were gathered during the analysis: the treatment of hybrids, revaluation reserves/latent

[1] See the Comparison of the sectoral rules for the eligibility of capital instruments into regulatory capital, January 2007 (hereafter: "Report on part A) and the Report on the impact of the sectoral differences on the calculation of own funds of financial conglomerates, August 2007 (hereafter: "Report on part B). Both documents are available on the CEBS and CEIOPS websites.

[2] See the Comparison of the sectoral rules for the eligibility of capital instruments into regulatory capital, January 2007 (hereafter: "Report on part A) and the Report on the impact of the sectoral differences on the calculation of own funds of financial conglomerates, August 2007 (hereafter: "Report on part B). Both documents are available on the CEBS and CEIOPS websites.

gains, participations and the differences in consolidation approaches and methods foreseen by the Financial Conglomerates Directive.[3]

6. The IWCFC has involved the industry at an early stage of its analysis and included the comments from representatives from conglomerates, banks and insurers in its discussions.

7. Three general remarks can be made from the outset, which put the recommendations of the IWCFC in the right perspective:
   1. Analysis shows that it is difficult to obtain a genuine conglomerate perspective. The impact of the sectoral differences on the capital structure and management of a conglomerate would, however, seem to be small in practice.
   2. In early discussions, it appeared that harmonisation of sectoral rules across Member States rather than across sectors seemed to be of great concern to the industry.
   3. Currently banking and insurance regulations are a moving target. With the CEBS ongoing work on the definition of hybrids and the Solvency II upcoming regulation containing a new classification for own funds, one could hope to achieve in the meantime a cross-fertilizing effect through the exchange of ideas and cooperation in specific areas. The supervision of groups and the role of coordinating supervisors could help in realizing a natural alignment of practices. From a regulatory perspective however, at this stage it remains difficult to achieve global view.

8. Taking the above mentioned comments into account, the outcome of the discussions has led the IWCFC to formulate following recommendations:

Hybrids

9. Hybrid capital instruments are not yet explicitly addressed by EU legislation. Their eligibility as regulatory capital differs between the sectors.

10. 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). The European Commission plans to transpose the requirements of the Sydney Press Release into EU legislation. CEBS has developed a proposal for an EU common definition of Tier 1 hybrids which will form the basis for Advice to the European Commission on this issue.

[3] Directive 2002/87 of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (hereafter: "FCD").

11. In the insurance sector there are no internationally accepted minimum requirements for "hybrid instruments" comparable to the Sydney Press Release. In most Member States, hybrids are admitted in as much as they meet the requirements laid down by articles 16.3 and 27.3 of the Insurance Directives with regard to subordinated instruments and subject to the limits laid down for these instruments.[4] In 2005, CEIOPS considered possible changes to the prudential treatment of "deeply subordinated debt" under the current insurance Directives. However, no changes were made to the current insurance Directives and broader discussion is taking place in the context of Solvency 2; the new approach to the definition and classification of own funds will be tested in a fourth quantitative impact study (QIS4) from April till July 2008.[5]

12. It is proposed that sectoral rules concerning the treatment of hybrids are harmonized and that hybrid instruments that meet certain requirements should be eligible for inclusion in the available solvency margin of insurance companies as well as in Tier 1 capital of banks.

13. The principles and requirements for eligibility should be the same for banks and insurance companies. Differences between the two should not occur unless they reflect specificities of both sectors. If steps are to be taken in the short term, then provided the necessary legislative changes could be made, these changes could be modelled along the principles and requirements set out in the CEBS proposal; QIS4 results should be taken into account. Harmonisation among sectors should occur at the latest with the implementation of Solvency 2.

Unrealised gains

14. When balancing the views on the treatment of unrealised gains, it seems that the issue essentially is a valuation issue, which at the same time requires a consistent approach on the capital requirements.

15. Some industry representatives from the banking and insurance sector agree that there is room for harmonisation on the treatment of revaluation reserves at the level of financial conglomerates. However, at the same time sectoral specificities seem to justify the fact that the treatment of revaluation reserves and latent gains differ in the two sectors.

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[4] Directive 2002/83 of the European Parliament and of the Council of 5 November 2002 concerning life assurance ("recast Life Directive") and the First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance as amended by Directive 2002/13/EC of the European Parliament and of the Council of 5 March 2002 as regards the solvency margin requirements for non-life insurance undertakings ("First Non-Life Directive").

5 Report foreseen for November 2008.

16. It is not clear yet whether, and if so to what extent, valuation methods should or could be aligned. At this stage, the IWCFC recommends to strive for consistency in the national transposition of the sectoral directives and the national application of prudential filters across the EU.

Participations/Holdings

17. While the sectoral rules for banks and insurers are identical regarding the mandatory deduction of holdings in insurers, they currently contain different limits when the held entity is a bank[6]. When the holder belongs to the insurance sector a deduction of the holding is mandatory if it exceeds 20% of the held entity's own funds, or if there is a durable link. When the holder belongs to the banking sector a deduction of the holding is mandatory if it exceeds 10% of the held entity's own funds, or if and as far as the aggregated amount of smaller holdings exceeds 10% of the holder's own funds.

18. The reason for deducting holdings held by the banking or insurance sector in banks or insurers is the avoidance of double gearing of capital. There are possible explanations for different limits in both sectors, although none is made explicit in any text.

19. It has, however, yet to be ascertained whether the theoretical arbitrage possibilities that may arise from the existing differences, e.g. by transferring a holding in a bank from the banking to the insurance part of the same financial conglomerate in order to avoid deduction, also has a practical relevance that might require amendments of the sectoral rules. For this reason, the IWCFC does not recommend one option as the solution, but rather presents the possible directions an alignment could take.

Methods

20. Although the aim of the exercise was neither to compare nor to review the calculation methods proposed by the FCD, the analysis did point out some issues linked to the methods of consolidation that should be recorded and feed into future work in the review of the FCD.

21. Analysis showed method 3 (book value/requirement deduction) to be too simplistic and to deliver doubtful results.

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[6] The terminology used by Directive 2006/48 (CRD) is *credit and financial institutions*. However, *'financial'* in the common language may also embrace the insurance sector — as opposed to the industrial etc sectors. For the sake of avoiding ambiguity the present report avoids to use the word 'financial' and tends to use expressions such as 'bank' or 'banking…' as referring to 'credit and financial' institutions' as defined by the CRD.

22. Method 1 (accounting consolidation) would be consistent with the banking sector. At the same time, it needs to be pointed out that the accounting consolidation method is being proposed by the Solvency II Draft Framework Directive as the default calculation method – the alternative being the deduction and aggregation method. Also under Solvency I, the consolidation method is the most common method adopted throughout the EU.

23. Therefore the accounting consolidation method is being proposed as the default method. However the supervisory authorities should have the discretion, for example in case of lack of integration, to require companies to use the deduction and aggregation method or a combination of methods.

24. Concerning the application of the consolidation method, harmonization on supervisory practices should be sought also on the features of the method itself, e.g., scope of consolidation (where different from that envisaged by accounting standards) or treatment of some items (e.g. minority interests)

Introduction

25. On 21 June 2007, the European Commission has sent the formal Call for technical advice to the IWCFC on 'Sectoral rules on eligible capital and analysis of the consequences for supervision of financial conglomerates.

26. The Call for advice (CfA) is divided in three parts. The first part was completed and published in January 2007 (Part A, Comparison of the sectoral rules on own funds). The second part has been published on 31 August (Part B, Analysis of the impact on conglomerates of the differences in the sectoral rules).[7]

27. The last part of the CfA invites the IWCFC to make 'any recommendations for action that it considers would be appropriate to address the consequences of the differences identified in the first two parts of the CfA for the supervision of financial conglomerates'.

28. In its two previous reports, the IWCFC has identified 4 main differences which could have a significant impact on the supervision of financial conglomerates:
    - Different treatment of hybrid capital instruments;
    - Different treatment of unrealised gains and revaluation reserves;
    - Different thresholds for deduction of participations;
    - Different methods and approaches to consolidation.

29. In addition, analysis showed that the limits to inclusion of eligible elements also differ.

Methodology

30. Currently, the rules on capital are under review in the banking and insurance sector (under a Commission's call for advice to CEBS on own funds for the banking sector, for the insurance sector, as part of the overall discussion on Solvency II). Therefore, the IWCFC considers that in this moving context, it is crucial to involve market participants at an early stage in the thinking concerning the financial conglomerates.

[7] See the Comparison of the sectoral rules for the eligibility of capital instruments into regulatory capital, January 2007 (hereafter: "Report on part A) and the Report on the impact of the sectoral differences on the calculation of own funds of financial conglomerates, August 2007 (hereafter: "Report on part B). Both documents are available on the CEBS and CEIOPS websites.

31. The IWCFC has consulted the industry at each stage of the Call for Advice, by inviting stakeholders to express their views on the key findings of the first two reports. For drafting the recommendations, the IWCFC organised a roundtable with interested parties.

32. The IWCFC aimed at understanding what problems financial conglomerates experience in practice with regard to own funds and what impact the sectoral differences have on their capital management and group structure. To this end, the IWCFC sought to understand the rationale for these differences. On the basis of its analysis, the IWCFC has to great length discussed potential policy options for addressing the identified difficulties arising from the sectoral differences.

33. When elaborating on these recommendations, the IWCFC applied the following underlying principles:

    a. The regulatory capital of the conglomerate should cover adequately the risks and the activities undertaken by the conglomerate[8];
    b. The regulatory capital should not be determined by arbitrage opportunities created by inconsistent rules;
    c. The challenge is to overcome a discussion based on the mere confrontations of sectoral perspectives and to reach a view reflecting the group-wide perspective required for the supervision of conglomerates;
    d. Supervisors of a conglomerate expect that own funds are the most current and relevant and reliable measure for the actual risk bearing capital.
    e. Cross-sectoral harmonisation within conglomerates should not come at the expense of the consistency of treatment of conglomerates and non-conglomerates.

34. A formal consultation on this report has been held from January till March 2008, and stakeholders were invited to a meeting for expressing their views on the draft recommendations. The recommendations will be submitted to the EC by the end of March 2008.

[8] The recital of the FCD explicitly states that the supplementary supervision intends to address loopholes on the present sectoral legislation and additional prudential risks to ensure sound supervisory arrangements with regard to financial groups with cross-sectoral financial activities.

General remarks on the justification and rationale for the differences

35. Analysis showed that sectoral differences are mainly due to the different definitions of own funds across sectors or to the different treatment of the elements in the banking or insurance sector in the capital requirements.

36. Therefore, these differences can be addressed either by aligning the definition in the sectoral rules and/or by aligning the capital requirements in the sectoral rules.

37. For example, with regard to hybrid capital instruments, one could argue that because both businesses have access to the same capital market, there seems to be no justification for having a different definition of this instrument eligible as regulatory own funds across the sectors. The aim should therefore be the alignment of the definition of eligible elements.

38. The discussion showed also that one of the main causes for the differences in the definition of own funds lies in the valuation rules for assets and liabilities, especially with regard to the acceptance of revaluation reserves and unrealised gains.

39. Solvency 2 will be characterised by a single valuation approach, whereas the banking sector is characterised by different valuation approaches, for the banking book and the trading book.

40. When the different risk profile of banking and insurance activities comes into play, a different treatment of the capital elements would be justified. In that case, it is technically sound to reflect the differences in the capital requirements, rather than in the definition of the elements.

41. It remains unclear to what extent the differences that have been described and analysed in previous work of the IWCFC do have an impact in practice on management choices regarding the capital and the structure of financial conglomerates. Interviewed market participants underlined that they do not consider these differences as drivers for capital management (see para 12 second bullet of report on part B).

Hybrids

Background

Definition of hybrids

42. In recent years, new types of capital instruments have been designed that enable banks and insurance companies to raise funds in a cost-efficient and less dilutive way. The instruments have similar characteristics but not the same quality as core original own funds.

43. The differences begin with the terms used to describe these instruments. The report on part A contains some explanation on the definition and use of hybrids in both sectors:

    a. In the banking sector, various terms are used. The industry and international rating agencies commonly refer to '**hybrids'**, as the capital instruments combine features of both debt and equity. Preferred shares are most of the time 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 so-called Sydney Press Release issued by the Basel Committee of Supervisors on 27 October 1998. However, 'innovative' may be restricted to a specific part 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.

    b. For the insurance sector, CEIOPS acknowledges the use of the terms "hybrid" and "innovative" capital. **"Hybrid" capital** is generally understood as capital that has features both of equity and debt and covers a variety of instruments. These instruments generally provide for the loss-absorption capacity of the debt and unpaid interest; they may for instance provide for a step-up of interests. **"Innovative" capital** generally refers to capital instruments which either are not defined under the current Directives, or which are not adequately captured. 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 and

hence might therefore not be adequately reflected in the existing limitation system. The definition is not exempt from a certain 'vagueness' (as e.g. what is 'innovative' in the insurance sector might not be 'innovative' in the banking sector) but is nonetheless currently used. So far most Member States have not identified any signification use of innovative instruments in the insurance market. [9]

Current national regulatory treatments

44. Hybrids are not yet explicitly addressed by EU legislation. Banking supervisors and insurance supervisors have been asked to consider the eligibility of these instruments as regulatory own funds and developed a range of sector- and Member State-specific practices.

45. **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).

46. As the Directive 2006/48/EC has not been updated to specify a common treatment of hybrid instruments, supervisors have tried to apply consistently a set of three main criteria: permanence, loss absorption and flexibility of payments.

47. There are no international accepted minimum requirements for "hybrid instruments" **in the insurance sector** comparable to the Sydney Press Release. Some Member States have, in this respect, made use of the principles established in the Sydney Press Release as a basis for deciding on the eligibility of such instruments. At least one Member State allows for hybrid instruments to be taken into consideration above the required solvency margin. In most MS, hybrids are admitted in as much as they meet the requirements laid down by articles 16.3 and 27.3 of Insurance directives (subordinated instruments) — which seems generally to be the case — and subject to the limits laid down for these instruments (50% of the lesser of the available or required solvency margin).

48. In 2005, CEIOPS considered possible changes to the prudential treatment of "deeply subordinated debt" under the current insurance Directives. The proposal was that deeply subordinated debt be allowed up to 15% of the required solvency margin and, given their financial characteristics,

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[9] Report on the implementation of the current Insurance Directives with regard to the eligible elements to meet the solvency margin, August 2007, CEIOPS-P1-14-07, http://www.ceiops.eu/media/files/publications/submissionstotheec/Reportonimplementationoftheinsurancedirectiveswithregardtotheeligibleelementstomeetthesolvencymargin.pdf.

considered separately from perpetual subordinated debts, which should not exceed the current limit of 50% of the solvency margin. CEIOPS concluded the proposal was technically feasible. However, no changes were made to the current insurance Directives and broader discussion is taking place in the context of Solvency 2.

49. On 7 December 2007 CEBS published a draft proposal for a common EU definition of Tier 1 hybrids for public consultation until 22 February 2008 (for details please see http://www.c-ebs.org/press/documents/CP17_draft%20proposal%20on%20hybrids.pdf) The proposal answered a letter by the European Commission requesting CEBS to develop general principles with regard of the three main economic features of Tier 1 capital (permanence, loss absorption and flexibility of payments), to seek convergence on the limits for inclusion of Tier 1 hybrids and to consider grandfathering options to limit the impact of any future common approach on the financial markets. The consultation paper builds largely on the principles and requirements set out in the Sydney Press Release as well as on the outcome of quantitative and qualitative surveys of the current treatment of hybrid capital instruments across the EU previously conducted by CEBS according to a Commission's Call for Advice. Following the consultation, CEBS has published its advice to the EC on 4 April 2008 [http://www.c-ebs.org/press/20080403.hybrids.htm].

50. On 10 July 2007, the European Commission published the Framework Directive Proposal for Solvency 2. The Proposal contains a new system for classification and eligibility of own funds in the insurance sector, based on a three-tier system. Eligible elements will be classified according to the following main criteria: subordination, loss absorbency, permanence, perpetuality and absence of mandatory servicing costs[10]. In its fourth quantitative impact study (QIS4) CEIOPS has interpreted those characteristics and proposed a detailed list of tiers, where hybrid elements can belong to Tier 1, Tier 2 or Tier 3 basic own funds, or Tier 2 or 3 ancillary own funds depending on the level to which they fulfil the characteristics.[11]

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[10] Proposal for a Directive on the taking-up and pursuit of the business of insurance and reinsurance (COM 2007/361, hereafter: Framework Directive Proposal), Art. 92.

[11] CEIOPS, QIS4 Technical Specifications, para TS.V.C.5 ff., available at http://www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/CEIOPS-DOC-23-07%20QIS4%20-%20Technical%20Specifications%20%20Rev.pdf. The specifications are under consultation by the European Commission till 15 February 2008, see http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm#qis4.

Relevance and rationale of the difference

51. Market participants indicated that reasons for banking institutions to use hybrid capital instruments are that this allows them to raise funds in a cost-efficient and less dilutive way and that they have been designed to be included in eligible regulatory original own funds. This influences the cost of capital for the undertaking and forms part of strategic business decisions.

52. Market participants indicated that there were no reasons grounded in business specificities that could justify that hybrids are not recognized in the insurance sector as they are in the banking sector. The industry therefore argued for a common definition of such instruments, with principles for eligibility modelled closely on Basel requirements.

53. It was pointed out that the Sydney Press Release was specifically drafted to meet the requirements of banks and thus has no immediate relevance for insurance companies. Furthermore, there are so far no experiences with these instruments as components to meet the required solvency margin. Hybrids might prove to be not appropriate as banking and insurance businesses have different time horizons and therefore may require different types of capital components.

54. The relevant insurance directives do not pre-empt any decision on the inclusion of hybrids. Provided it can be ensured that the quality of hybrids equals that of 'classic' Tier 1 (i.e. original own funds/required solvency margin) components the members saw no reason not to modify sectoral rules and allow the inclusion of hybrids also in the available solvency margin of insurers at sectoral level.

55. This would also open insurers an access to wider capital markets.

56. Concerns regarding specificities of the insurance business should be met rather by specific requirements than by a general exclusion of hybrids from insurance "Tier 1".

Recommendation

57. Hybrid instruments that meet certain requirements should be eligible for inclusion in the available solvency margin of insurance companies. The principles and requirements for eligibility should be the same for banks

58. If steps are to be taken in the short term, then provided the necessary legislative changes could be made, these changes could be modelled along the principles and requirements set out in the CEBS advice when finalised. The results of the work of CEIOPS following its fourth quantitative impact study (QIS4) due in November 2008 will also need to be taken into account. Harmonisation should occur at the latest with the implementation of Solvency 2.

Revaluation reserves and unrealised gains

Background

59. According to para 27 of the report on part B, it is assumed that conglomerates apply IAS/IFRS in their consolidated accounts for statutory purposes. It is worthwhile noting that for supervisory purposes, data stemming from IAS/IFRS consolidated accounts might be subject to prudential filters according to CEBS and CEIOPS guidelines. To this regard, especially concerning the insurance sector some difference might arise throughout MS in relation to the national accounting standards in force[12].

60. The revaluation reserves (unrealized gains shown on the balance sheet) relate mainly to available for sale (AFS) assets under IFRS and to properties (own use or investment)[13].

61. The prudential treatment of these elements is summarized in the following table:

Treatment under CRD	
Capital	**Capital Requirement**
Revaluation reserves are partially included in Tier 2. Some prudential filters are applied for banks using IFRS: - AFS equities and properties; gains partially in Tier 2 and losses in Tier 1; - AFS loans and receivables: neutralisation of gains and losses - AFS debt securities: same treatment as AFS equities or AFS loans and receivables. - Unrealized gains on properties: same treatment as equities.	A capital requirement is imposed on the book value of the assets. This capital requirement is therefore not necessarily based on a market value approach for assets.

[12] Para 423 of report on part A concerning prudential filters: "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 sales assets have the characteristics foreseen by the national solvency regime."
[13] Under the banking regulation, AFS assets and properties are generally included in the banking book.

Treatment under Solvency I	
Capital	**Capital Requirement**
The revaluation reserves may be included in own funds without limit. Some prudential filters may be applied. Filters are envisaged in CEIOPS guidelines, some of them similar those applicable in the banking sector[14]. The application of the prudential filters in the insurance sector is related to the national accounting standard in force (see footnote 10).	Not applicable n/a.
Treatment under Solvency II	
Capital	**Capital requirement**
The revaluation reserves relating to all assets are included in own funds in application of the Solvency II market consistent valuation rules.	Capital requirement covering general market risk and specific market risk (i.e. spread risk).

62. On basis of the banking and insurance directives, the revaluation reserves are allowed to be included in own funds of both sectors. The only difference between the sectoral directives relates to the Tier 2 limit. As mentioned in the report on part B, the fact that the limit is different has only an impact on the qualification of revaluation reserves as cross-sectoral or non-cross-sectoral own funds in the consolidated method[15].

63. The application of the so-called "prudential filters" for the inclusion of revaluation reserves is not defined by the sectoral directives but by the supervisory authorities, hence practices differ between the banking and insurance sectors as well as across Member States. In the banking sector CEBS has recently published an analysis of the implementation and impact of its prudential filter guidelines[16]. One of the key findings was that nearly all EEA countries comply with the CEBS guidelines and the filters introduced by Directive 2006/48/EC. The findings of the report were also discussed with industry representatives in an open hearing on 16 October 2007. .

[14] For a detailed illustration of the filters and for the comparison with those in force in the banking sector, see report on part A, Chapter 7.
[15] See paragraph 43 ff.
[16] (see http://www.c-ebs.org/press/documents/145Final_Analytical_report_on_prudential_filters.pdf). A summary of the discussion has been published under http://www.c-ebs.org/documents/SummaryPHprudentialfilters16102007.pdf

64. The unrealized latent gains on assets (which do not appear in the balance sheet) relate to all assets on the balance sheet. The prudential treatment is summarized in the following table:

Treatment under CRD	
Capital	**Capital Requirement**
Not included in own funds.	N/a.
Treatment under Solvency I	
Capital	**Capital Requirement**
May be included in own funds after supervisory approval, when of non-exceptional nature.	Not applicable.
Treatment under Solvency II	
Capital	**Capital requirement**
Latent gains and losses relating to all assets are included in own funds in application of the Solvency II market consistent valuation rules.	Capital requirement covering general market risk and specific market risk (i.e. spread risk).

Relevance and rationale of the difference

65. If the conglomerate applies IFRS, latent gains and losses will relate mainly to real estate properties (investment and own used) valued at cost and financial instruments valued at amortised cost (financial assets held to maturity and loans and receivables). Under IFRS, the conglomerate may also choose to value its real estate properties at fair value to reduce the impact of the difference concerning latent gains, but valuation of financial assets at fair value is subject to the restrictions of IAS 39 and can only be achieved partly.

66. When balancing the pros and cons, it seems that the issue essentially is a valuation issue, which at the same time requires a consistent approach on the capital requirements. Solvency II favours a "total balance sheet approach" where own funds are defined by the difference between the value of assets and liabilities measured on the basis of a "consistent market valuation rule", or full fair value. In this approach, the unrealized gains and losses on assets (and liabilities) are taken into account automatically in own funds and without limits. The capital requirements must also be consistent with this approach.

67. Some industry representatives from the banking and insurance sector basically agree that there is room for harmonisation on the treatment of revaluation reserves at the level of financial conglomerates. However, some insurance industry representatives point out that sectoral specificities may justify the fact that the treatment of revaluation reserves and latent gains is less stringent in the insurance sector. This would be due to the fact that assets in the insurance sector are said to be more liquid than in the banking sector and that due to the long duration of their liabilities insurance companies are not obliged to realize certain assets immediately.

Recommendation

68. The treatment of revaluation reserves and unrealized gains is closely linked to the different valuation methods used in the two sectors. It is not clear yet whether and if so to what extent valuation methods should/could be aligned. At this stage, the IWCFC would recommend to strive for consistency in the national transposition of the sectoral directives and the national application of prudential filters across the EU.

Deduction of holdings

Background

69. One of the differences that have been identified between insurance and banking sectors is related to the treatment of holdings or participations[17] in banking institutions. The report on Part A of the CfA explained that the difference is mainly due to the fact that while for the insurance sector the rules for intra- and cross-sectoral holdings are the same — i.e. they are the rules introduced by the FCD — (see table hereunder, rectangles *1* and *2*), the banking sector distinguishes between intra-sectoral deductions and cross-sectoral deductions (see rectangles *3* and *4*).

	Holdings in banks	Holdings in insurance undertakings
Insurance group	Deduction if > 20% of the held entity or, if less, in case of durable link 1	Deduction if > 20% of the held entity or, if less, in case of durable link 2
Banking group	Deduction if >10% of the held entity or, if less, the total amount exceeding 10% of own funds of the holder 3	Deduction if > 20% of the held entity or, if less, in case of durable link 4

70. Article 57 (l) of the CRD[18] requires that holdings held by a banking group in other banking institutions, regardless of their inclusion in the banking or in the trading book and amounting to more than 10% of their capital, must be deducted. Moreover, Article 57 (n) requires that holdings in other credit and financial institutions of up to 10% of their capital must be deducted as far as the total amount exceeds 10% of the holder's own

[17] Article 17 of Dir.78/660/EEC on the annual accounts of certain types of companies defines a *participating interest* as rights in the capital of a company which, by creating a durable link, are intended to contribute to the company's activities, and states that such participating interest is presumed where it exceeds a percentage fixed by Member States which may not exceed 20%; it does not use the word *participation* in the sense of holding a participating interest. Article 2.11 of FCD defines a *participation* as either a participating interest in the sense of the 1st sentence of Article 17 of Dir.78/770, or as the direct or indirect ownership of 20 % or more of the voting rights or capital of an undertaking. In the common language, a participation means that someone participates in a company, without reference to its durability or to a specific percentage of held capital or voting rights. A *holding* generally refers to any direct or indirect ownership in another undertaking without any further qualification, including holdings held in the trading book.
In this report and unless otherwise specified, *participation* is used as synonymous of *holding*, and not with the specific meaning of Article 2.11 of the FCD.

[18] Directive 2006/48 of the European Parliament and of the Council of 14 June 2006 on the taking up and pursuit of the business of credit institutions ("CRD").

funds. Subordinated claims and other capital instruments are included in these two tests.

71. These deductions are made half from original own funds, half from additional own funds; with a transitory provision.

72. The IWCFC considered that regulatory arbitrage, if any, stemmed from the possibility of transferring a held entity from one sector from the other, i.e. the possibility from transferring a holding (in a bank or in an insurer) from a banking group to an insurance group (that is, from rectangle 3 to rectangle 1, or from rectangle 4 to rectangle 2), or vice-versa (from R1 to R3 or from R2 to R4).

73. In present legislation, deductions rules applying to holdings in an insurer are identical whether the holder is an insurer (rectangle 2) or a bank (rectangle 4). Deduction rules applied to holdings in a bank differ whether the holder is an insurer (R1) or a bank (R3).

74. In practice, the difference of treatment of holdings in banks or in insurers according to the quality of the holder seems to be limited. When consolidated in the accounts, the holding is identically treated whether the holder is an insurance or banking group. There only remains a difference if the holding is not consolidated in the accounts.

75. In the insurance sector, if no deduction is been made, the risk of holding the participation will need to be covered by the capital requirements.

76. At the conglomerate level, a holding in a bank between 10% and 20% held by the banking part of the conglomerate (rectangle 3) must be deducted, but it need not to be deducted if it is held by the insurance part of the conglomerate (rectangle 1).

77. The report on Part B of the CfA confirmed that, theoretically, this difference can have an impact on the composition and amount of regulatory capital of a financial conglomerate. The report tested the hypothesis where deduction is applied under both sectoral rules (vs. where the option not to deduct has been taken up). Using consolidation methods 1 and 2 as set out in the FCD, the holder of such holding is relevant. Depending on the method used, it could be more advantageous if holdings of more than 10% and less than 20% are held by an insurer rather than by a bank in order to avoid a deduction.

Relevance and rationale of the difference

78. The principles underlying deductions of holdings or participations in the banking and insurance sectors are very similar, that is to ensure that capital items are only used once to support banking or insurance activities where a bank or an insurer has interests in other banking or insurance undertakings. Thus the reason for deducting holdings held by banks or insurers in the banking or insurance sector is mainly to avoid the double use of the same capital by more than one banking or insurance institution (known as "double gearing"). [19]

79. It appears that there is no explicit reason in the texts why the two thresholds for holding a banking institution are different whether the holder belongs to the banking or the insurance sector.

80. However, the absence of explicit reason in the texts does not mean that the differences are unfounded. Banks conduct many operations between themselves; accordingly the failure of one is deemed to have consequences on the many others which have interrelated operations with the former. Thus banks' holding important participations in other banks would add a risk in capital to the current 'operational' risk: this calls for stringent limits to such participations. On the other hand, and with an exception for reinsurance activities, insurers rarely conduct operations between themselves. Accordingly, the failure of one, while harmful to its policyholders, will have little consequences on other insurers: this calls for less stringent limits for holdings in insurers

81. These aspects as well as the question whether the existing differences may result in regulatory arbitrage should be taken into account when considering whether and how to align the current sectoral rules.

82. The IWCFC is also of the view that it is too simplistic to focus solely on the thresholds as the only indicators independently of how rules globally work.

83. Industry representatives indicated at various occasions that in current practice, the difference in quantitative thresholds does not seem to lead to regulatory arbitrage. Additionally, it was pointed out that the impact of the different thresholds would be low because it only affects holdings in banks between 10 % and 20 %. Some market participants noted that it would not be straightforward to just displace a holding in a bank from the banking sector to the insurance sector. One market participant noted that

[19] Although it seems that Article 6.5 of the FCD, which stipulates that entities that collectively are of non-negligible interest, should be included in the calculation of the supplementary capital, holds the same general idea as Article 57 (n) of CRD, the report did not test the practical application of both rules.

for the sake of clarity, it applies the 10% threshold as an example of a conglomerate not choosing to play with regulatory arbitrage. However, some industry representatives explicitly concluded that the risk of regulatory arbitrage could be further investigated and the cross-sectoral alignment kept under consideration in order to ensure a level playing field.

84. Additionally, banking industry representatives raised the inconsistent application of the definition of the qualitative criterion of durable link across Member States. In this context, some banking stakeholders suggested as a possible solution to remove the qualitative criterion and link the definition of holdings to the 20% threshold.

85. As a consequence of the above, the IWCFC would not favour recommending any change of a rule without due assessment of whether it creates more benefit than problems, especially for banking groups that are not conglomerates.

86. In that respect, the IWCFC discussed several possibilities including:

   a. No change;

   b. Apply a more stringent threshold to holdings in banks held by insurance groups, e.g. adopt the current most stringent 10% threshold of the CRD;

   c. Apply a less stringent threshold to holdings in banks held by banking groups, for example, by requesting that:

      - holdings in banks must be automatically deducted if the conglomerate holds, directly or indirectly, **20 % or more** of the voting rights or the capital of the bank. The option not to deduct would remain as an alternative to deduction. In this case, however, the holding would have to be consolidated.

      - For holdings under 20 % in a bank, a deduction could be required if the holding aimed to create a durable link with this undertaking, by developing the activities of the conglomerate or influencing the management of this undertaking, see below (d).

   d. A common approach to holdings in banks, in particular in the assessment of durable link/durable influence:

The existence of a durable link could be assessed for supervisory purposes following a common approach, for example, in the following circumstances:

- when the FC holds 10 % or more of the capital or the voting rights;
- the FC appoints some representatives in the board of directors of the undertaking;
- the FC is part of an agreement, with the undertaking or other shareholders, which enables him to have an influence on the management or to develop joint activities with the undertaking ;
- there are conventional conditions or unilateral commitments which limit the ability of the FC to exercise freely its rights pertaining to the shares, notably the ability to sell it;
- commercial links between the undertakings (cross-selling, joint products and distribution lines) and intra-group transactions.

If the supervisor concludes that a durable link exists, the FC would have the burden of proof for refuting this rebuttable presumption.

e. A provision empowering the authority in charge of supplementary supervision on the conglomerate with the power to impose the deduction of holdings in the banking sector between 10% and 20% where their allocation in the insurance side of the conglomerate results (is an evident mean for) (in) a purely nominal increase of own funds at the conglomerate level;

f. Aligning or bringing closer the rules applying to holdings in insurers and to holdings in banks, by requiring that:

- holdings in banks and insurers must be automatically deducted if the conglomerate holds, directly or indirectly, 20 % or more of the voting rights or the capital of the undertaking. The option not to deduct would remain as an alternative to deduction. In this case, however, the holding would have to be consolidated.

- For holdings **under 20 %** in a bank or an insurer undertaking, a deduction would be required if the holding aimed to create a **durable link** with this undertaking, by developing the activities of the conglomerate or influencing the management of this undertaking, see above (d).

87. On the other hand, the IWCFC considered that it was not appropriate to align Article 57 (n) of the CRD across both sectors. It is not conceivable to extend the rule to the insurance sector mainly because such rule has not much foundation when the holder is an insurer, but also because its application to insurers holders would turn out to be erratic, since the own funds of insurers only partly embrace the prudence — a tangible, variable across jurisdictions and insurers, part of it being posted in the technical provisions; thus the own funds of an insurer owner is not an appropriate reference. It is neither conceivable to suppress the rule from the banking sector because it is well founded in this sector.

Recommendation

88. The IWCFC has gathered from the consultation of the industry that in current practice the difference in quantitative thresholds does not seem to lead to regulatory arbitrage. The application of the qualitative criterion with regard to the durability of the link across Member States seems to be of greater concern.

89. Therefore, at this stage, the IWCFC recommends to further gather evidence of potential regulatory arbitrage before putting forward a recommendation that could cause unintended consequences at sectoral level. The IWCFC recommends striving for consistency in the national transposition of the sectoral directives, for example in the application of the qualitative assessment of the participation with regard to the durability of the link.

Methods of calculation

Background

90. Although the aim of the exercise was not to compare nor review the calculation methods proposed by the FCD (Accounting consolidation; Deduction and aggregation; Book value/Requirement deduction) in order to assess the nature and impact of the differences in the sectoral rules the IWCFC did use the three methods of consolidation in working example calculations. This work did point out some issues linked to the methods of consolidation that should be recorded and feed into future work in the review of the FCD.

91. In principle the 3 methods are intended to deliver broadly the same result. In practice the examples the IWCFC worked out, showed that method 3 (Book value/Requirement deduction) could produce a significantly different result from methods 1 (Accounting consolidation) and 2 (Deduction & Aggregation). The results of methods 1 & 2 were broadly similar.

Relevance and rationale of the difference

92. The calculation methods show differences and different advantages and disadvantages in calculating the supplementary capital requirements of financial conglomerates.

93. Method 1, the accounting consolidation method has the advantage of using statutory group accounts, which have been audited and do not require separate prudential calculation. Additionally, this method automatically eliminates double gearing.

94. The accounting consolidation method, however, requires an adjustment for the difference between the scope of statutory consolidation (all entities) versus prudential consolidation (regulated entities + some other related entities + financial /insurance holding companies).

95. Method 2, the deduction and aggregation method shows more granular information available as it is built up from relevant individual entities.

96. This method, however, requires a separate prudential calculation, as well as the elimination of double gearing.

97. Method 3, the book value/ requirement deduction method, is a simple method. It is, however, merely based on the position of the parent undertaking, without recognition of the value of subsidiaries. A major disadvantage of this method is that results are different depending on the ultimate parent of the conglomerate, whether it is an insurance company or a bank.

98. Based on this analysis, the next question is whether these differences between the calculation methods are justified.

99. On the one hand, an advantage of having the option of different calculation methods would be that it would allow the calculation to be tailored to the different structures of conglomerates. A single method would not necessarily be more comparable. Given the different structure of conglomerates and the different markets in which they operate.

100. Options would also make it easier to take account of sectoral differences. And taking into account that the supervision introduced by the FCD is of a supplementary nature, options could reduce the burden of imposing a one-size-fits-all requirement on conglomerates.

101. On the other hand, one could argue that a single method with no options would improve the consistency and comparability of results, thereby guaranteeing a more level playing field by avoiding cherry picking.

102. IWCFC members expressed their view on the methods, indicating that method 3 (book value/requirement deduction) has been shown to be too simplistic and to deliver doubtful results. It should also be pointed out that this method is very rarely used. Furthermore, in its previous recommendations on the possible need for amendments to the Insurance Groups Directive, CEIOPS suggested deleting this method.[20]

103. Method 1 (accounting consolidation) would be consistent with the banking sector. At the same time, it needs to be pointed out the accounting consolidation method is being proposed by the Solvency 2 Framework Directive Proposal as the default calculation method – the alternative being the deduction and aggregation method.[21]

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[20] CEIOPS Doc 04/05 Recommendations on possible need for amendments to the Insurance Groups Directive,http://www.ceiops.org/media/files/publications/standardsandmore/guidelines/recommendations_DOC0504.pdf, para 7.3.1.
[21] Framework Directive Proposal, article 237 and 240.

104. However, as already illustrated in the report on Part A, para 318-319, the practical application of the consolidation method is similar in the banking and insurance sector but it is not totally identical, so that similarities have to be examined in detail not to be misinterpreted. The main areas of difference are the scope of consolidation and the method of calculation (e.g. minority interest treatment)[22].

Recommendation

105. The accounting consolidation method is being proposed as the default method. However the supervisory authorities should have the discretion, for example in case of lack of integration, to require companies to use the deduction and aggregation method for some or all of the conglomerate group, or a combination of the methods.

106. In addition, it would be advisable that the cooperation among supervisors should be enhanced to achieve greater harmonisation and convergence in the practical application of consolidation method.

[22] Especially in the banking sector, this might give raise to overburden in calculation for conglomerates, that should perform two different calculations both at sectoral group and at Fico level (see report on part A, para 350ff). In the insurance sector, and especially if full consolidation envisaged by IAS 27 is applied, this overburden is likely not to be in place.