12 December 2006

Duncan Mackinnon
Solvency II Project
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Mr Mackinnon

CRO Forum response to FSA / HMT Discussion Document, "Supervising insurance groups under Solvency II"

We welcome this discussion document from the FSA and HMT which contains very useful principles for prudential supervision of groups in Solvency II.

The CRO Forum believes that these proposals are consistent with the Commission's Framework for Consultation on Solvency II[1] and with Commissioner McCreevy's recent statement at CEA's conference about the treatment of groups in Solvency II:

> "There clearly is no magic solution for [group supervision] but we need to overcome our fears and engage in creative thinking about a more appropriate division of tasks between the lead supervisor and the solo supervisors".[2]

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[1] See paragraph 6 in European Commission, "Amended framework for consultation on Solvency II", April 2006.

[2] C. McCreevy, "Shaping the future supervisory framework for insurance", CEA conference on Solvency II, November 2006.

As you know, the CEA and the CRO Forum have already expressed support for many of these proposals in the joint response to CEIOPS CP14 on group issues. The CRO Forum also supported other aspects of your proposals in our paper on diversification benefits from 2005.[3] We therefore support the approach for group supervision outlined in your discussion document. Our detailed comments are attached to this letter.

The CRO Forum believes that, if adequately implemented, this approach will streamline prudential supervision of groups while enhancing the access of solo supervisors to relevant information about the financial position of the group and their participation in decisions about the supervision of the group through the collegiate approach to supervisory review process. Furthermore, we believe this approach is a necessary component of harmonised group supervision and for appropriate convergence of supervisory practice. We will therefore recommend to the Commission and CEIOPS that they consider these proposals.

In line with the joint response from CEA and the CRO response to CEIOPS CP14, we wish to note that a key aspect of any approach for group supervision is harmonisation of valuations and that any proxy MCR for groups takes appropriate account of risks, diversification and risk mitigation and is adequately calibrated.[4]

We also appreciate that further work is needed to address the implementation issues that inevitably arise with group supervision (equivalence tests for third countries, treatment of Joint Ventures and non-EU subsidiaries of EU based groups). We are also well aware of existing deadlines for the framework directive. However, it is important that we maintain a sense of perspective:

- the application of the Lamfalussy approach to Solvency II means that the focus of the next few months must be the development of the principles for the framework directive (level 1 text) covering the issues raised in this paper and the appropriate implementation issues that inevitably arise with group supervision; clearly, some of them should also be addressed through level 2 measures within the same timescales as other Solvency II issues;

- these proposals will be implemented around 2010 so firms and EU supervisors will have adequate time to prepare for implementation.

[3] CRO Forum, “A framework for incorporating diversification benefits in the solvency assessment of insurers”, June 2005. This is available from the CRO Forum website (www.croforum.org, under publications).

[4] See page 5 in CEA and CRO Forum, “Feedback on CEIOPS consultation paper 14”, September 2006. The document is available from the CRO Forum website (www.croforum.org, under publications).

The CRO Forum will be happy to assist the Commission and CEIOPS in this work.

I am copying this letter to Paul Sharma at the FSA.

Yours sincerely

Thomas C. Wilson
Chairman, CRO Forum
Chief Insurance Risk Officer
ING Group

Annex: Detailed comments from the CRO Forum to FSA / HMT Discussion Document, "Supervising insurance groups under Solvency II"

Summary of Chapters 2 to 4 of FSA / HMT Discussion Document, "Supervising insurance groups under Solvency II"	CRO Forum response
2. The case for a fundamental review of group supervision	
By creating a harmonised valuation of insurance liabilities and a consistent calibration standard for capital requirements, Solvency II will dramatically simplify consolidated supervision of insurance groups.	We agree. Solvency II must seize the opportunities that harmonised valuations of insurance liabilities and risk-based capital requirements create to simplify and yet improve the supervision of insurance groups. **A key aim for the CRO Forum is that Solvency II results in a harmonised approach to group supervision and appropriate convergence of supervisory practice. We believe the approach in this discussion document, if adequately implemented, is a necessary element to achieve this.** **In line with the joint response from CEA and the CRO Forum to CEIOPS CP14, we note that any proxy MCR for groups based on solo MCR that is formulated and calibrated to be insensitive to risks and diversification or does not give due credit to risk mitigation may create artificial constraints and disincentivise the use of internal models and good risk management in groups regardless of the approach adopted for group issues.[5]**
Because of Solvency II's far greater scope and sophistication compared with Solvency I, retaining the current IGD approach to supervision would yield an unreasonable regulatory burden on insurance groups without contributing to policyholder protection.	We agree. The IGD addresses a very specific problem (double gearing) in the context of prudential supervision of legal entities that is not risk-based. It is also not clear to us why it would be appropriate to overhaul completely prudential supervision of legal entities while retaining most of the key features of prudential supervision of groups.

[5] See page 5 in CEA and CRO Forum, "Feedback on CEIOPS consultation paper 14", September 2006. The document is available from the CRO Forum website (www.croforum.org, under publications).

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By contrast a reformed approach to group supervision is key to a deeper Single Market in insurance services, and a more capital efficient EU insurance sector. Substantial benefits for policyholders can be achieved without reducing the strength of policyholder protection.	We agree. Indeed, we believe that a harmonised and cost-effective approach to prudential supervision of groups is a win-win strategy for Solvency II: deepening the Single Market and increasing capital efficiency while maintaining the strength of policyholder protection.
3. Group–wide diversification effects and group supervision	
Any solo SCR control level for insurance subsidiaries which reflects diversification effects arising at group level will be arbitrary.	We are aware of different approaches for allocating group diversification benefits to legal entities as suggested, for example, in the paper from Groupe Consultatif. As noted in the joint response from CEA and the CRO Forum to CEIOPS CP14, we believe that the size of the credit to local entities from group diversification benefits should be the same regardless of the method use.[6]
Solvency II should not impose arbitrary solvency control levels which vary between groups, or within a group, and which reflect different implied calibration standards.	We agree that lack of transparency of calibration standards is undesirable in Solvency II. The CRO forum has been a long-standing advocate of the importance of diversification benefits and in particular group diversification benefits.[7] In this context, we note that calibrating a subsidiary that does not need a high rating to a lower confidence level than the rest of the group should not be inappropriate provided the calibration is transparent. This would affect the distribution of capital requirements within the group and not the capital requirement at group level.
Effective supervisory co-operation is key for any risk-based prudential framework, especially given that the group SCR will be below the sum of the subsidiaries' SCRs.	We agree. Supervisory cooperation is vital for the success of Solvency II and must not be assumed. Instead, the design of Solvency II should include mechanisms in which co-operation is the natural outcome of the interaction between EU supervisors. We believe that the proposals in this discussion document contain appropriate mechanism for effective co-operation between EU supervisors.

[6] See note 1.

[7] CRO Forum, "A framework for incorporating diversification benefits in the solvency assessment of insurers", June 2005. This is available from the CRO Forum website (www.croforum.org, under publications).

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Pillar 2 for an insurance group should be consolidated into a single process at group level; the principle for co-ordination between supervisors should follow Article 129 of the Capital Requirements Directive.	We believe that the extent to which Pillar 2 assessment encourages good risk management in groups will be compromised if the process of Pillar 2 within a group (i.e. the assessment and review at the level of the parent and subsidiaries) is not coordinated. The CRO Forum has already expressed a view in favour of the adoption for prudential supervision of EU insurance groups of the process in Article 129 of the Capital Requirements Directive for model approval. We therefore agree with this recommendation.[8] We believe this approach would also increase the transparency of group supervision and the level playing field between EU groups. Solvency II would need to articulate the relationship between the group lead supervisor, solo supervisors and the committee of supervisors in detail to ensure a level playing field and supervisory convergence. A further benefit of this approach is to reduce materially the concerns expressed in the joint response from CEA and the CRO Forum to CEIOPS CP14 about the potential application of Pillar 2 actions at solo level.[9]
4. A proposal for group supervision under Solvency II	
The proposals advanced in this chapter aim to strike the right balance between an approach based on treating the group as a single economic entity across and on treating the group as a set of separate legal entities.	We welcome these proposals which go a long way to create an approach that strikes the right balance between the way the group is managed and the underlying legal entities. As noted in the joint response from CEA and the CRO Forum to CEIOPS CP14, we agree that there should be one binding SCR for groups and that the solo MCR and the valuations of the liabilities (including the Market Value Margin for non-hedgeable risks)

[8] See page 48 in CRO Forum paper cited in note 3.

[9] See note 1.

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	remain local and binding. We also agreed that a local SCR should be calculated to set the level of parent's support to the subsidiary.[10] The discussion document is silent as to whether the local SCR should be publicly disclosed or just communicated to the supervisor. The CRO Forum believes that, in principle, there should be a presumption of public disclosure in this case so that prudential supervision of groups is transparent. The CRO Forum also welcomes the proposals for a cost-effective approach for capital support within a group: • a requirement on the parent to provide capital support to the subsidiary if the local MCR is breached (paragraph 4.7); and • a clear limit about its extent; as we understand it: a one-off requirement to provide support up to the level of "the solo SCR, which reflects the group's commitments to policyholders" (paragraph 4.8). A key aspect that would need to be fleshed out in more detail in level 2 measures is the details of the enforcement mechanism, which may require that supervisors have powers over a parent similar to the powers over subsidiaries. In common with the proposals in CEIOPS CP14, it is also important that these proposals are implemented in a flexible manner to allow the specific circumstances of EU groups. This includes flexibility for deploying the capital around the group (and therefore allowing subsidiaries to support the parent using contingent capital instruments); and providing an appropriate treatment for Joint Ventures.

[10] See note 1.

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The proposals envisage complementary, not duplicated, responsibilities and powers for the supervisors of a group parent and its subsidiaries. Along with a consolidated supervisory review process this is essential to prevent a significant increase in the regulatory burden on insurance groups.	We agree. As noted earlier, we believe that an important aspect of group supervision is that it leads to supervisory convergence and a level playing field. In common with the proposals in CEIOPS CP14, the approach set out in this discussion document must be implemented through the Lamfalussy process to achieve this aim. We also believe that a further benefit of these proposals, in addition to those listed in paragraph 4.20, is that, compared to the current position under Solvency I, solo supervisors would have enhanced access to relevant information about the financial position of the group and to participation in decisions about group supervision through the collegiate approach in article 129 of the CRD.
Solvency II should aim to for a level playing field in prudential standards and decisions on the equivalence of a third country's solvency regime should be made by the EIOPC. Third country groups, in particular their EEA sub-groups, should benefit from diversification effects.	In the joint response from CEA and the CRO Forum to CEIOPS CP14, we also emphasised the importance of supervisory convergence and a level playing field for insurance groups. We therefore made a very similar suggestion, namely that the determination of the equivalence of the supervisory regime should be a matter for the Commission and Member States through level 2 measures.[11] We also note the comment in paragraph 4.24 about the additional procedure for determining equivalence of supervisory regimes under the Financial Conglomerates Directive, which we understand to be independent of the Solvency II reforms. We believe that in the long term, the Commission should work towards a single process for determining equivalence along the lines suggested here for the purposes of prudential supervision of banks, investment firms, insurance firms and financial conglomerates. We agree with the comment in paragraph 4.26 that third country groups should be allowed to benefit from diversification effects, subject to appropriate conditions. In common with the proposals in CEIOPS CP14 and as noted in the joint response from CEA and the CRO Forum, we recommended that:

[11] See note 1.

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	• for non-equivalent regimes, the group lead supervisor should be empowered to require the establishment of an EU holding company for the EEA part of the group;[7] • a supervisor outside the EEA who meets the requirement of equivalent supervision should be able to take full responsibility as group lead supervisor in a Solvency II context;[12] • EU based groups should have the possibility of recognising diversification benefits from equivalent and non-equivalent third country operations where they use appropriate means of capital support;[13] equally, the lead supervisor should also be allowed to accept their internal models;
EU groups must ensure that protection of their policyholders in the EU is not jeopardised by third country operations but if de facto Solvency II is applied to EU groups operating in third countries their competitiveness will be undermined.	We agree that managing a group as an economic entity (as opposed to a collection of legal entities) must not be done at the expense of increasing risks to policyholders. We are therefore in favour of good risk management at group level and supervisory cooperation. Equally, we are concerned that de-facto application of Solvency II standards to third country operations can undermine the competitiveness of EU insurance groups. As noted in paragraph 4.28 of the discussion document, "the commitments to the policyholders in third country subsidiaries in the event of insolvency must be defined by the third country regime". We very much agree with this observation and we believe that it is vital for structuring an approach for support of third country operations within Solvency II regardless of the approach adopted for group issues. Adopting this principle would avoid a situation where Solvency II undermines the competitiveness of EU insurance groups.

[12] See page 13 in CEA and CRO Forum paper cited in note 1.

[13] See page 12 in CEA and CRO Forum paper cited in note 1.

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The problems created by insolvency of an insurance subsidiary or a whole group are common to any proposal which recognises group-wide diversification benefits, and not specific to this proposal.	We agree. Further, we believe that the proposals contained in this discussion document will go some way to reduce these risks by allowing groups to manage their risks more effectively by moving eligible capital in excess of the solo MCR within groups. We also believe that the European Commission should use this as an opportunity to review the provisions in the winding up directive to ensure that they are consistent with these proposals and to provide a consistent treatment of insurance and re-insurance creditors in the event of default.