Olivia Johanna Erdélyi

Twin Peaks for Europe: State-of-the-Art Financial Supervisory Consolidation

Rethinking the Group Support Regime Under Solvency II

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Abbreviations

AAE	Actuarial Association of Europe
ACME	Association des Assureurs Coopératifs et Mutualistes Européens
AISAM	Association Internationale des Sociétés d'Assurance Mutuelle
AMICE	Association of Mutual Insurers and Insurance Cooperatives in Europe
BCBS	Basel Committee of Banking Supervision
BEPGs	Broad Economic Policy Guidelines
BOE	Bank of England
BRRD	Bank Recovery and Resolution Directive
BTS	Binding Technical Standard
CBA	cost-benefit analysis
CBI	central bank independence
CCI	Convergence and Competitiveness Instrument
CEA	Comité Européen des Assurances
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CFO Forum	European Insurance CFO Forum
CJEU	Court of Justice of the European Union
CRM	Provisions on the Supervision of Group Solvency for Groups with Centralized Risk Management
DGS	deposit guarantee scheme
DNB	De Nederlandsche Bank
EBA	European Banking Authority
EBC	European Banking Committee
EC	European Community
ECB	European Central Bank
ECBR	European Conduct-Of-Business Regulator
ECOFIN	Economic and Financial Affairs Council
EDIS	European Deposit Insurance Scheme

EDP	excessive deficit procedure
EEA	European Economic Area
EEC	European Economic Community
EFC	Economic and Financial Committee
EFSC	European Financial Stability Committee
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
EIOPC	European Insurance and Occupational Pensions Committee
EIPA	European Institute of Public Administration
EMU	Economic and Monetary Union
EP	European Parliament
ESA	European Supervisory Authority
ESC	European Securities Committee
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FCD	Financial Conglomerates Directive
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSCS	Financial Services Compensation Scheme
FSF	Financial Stability Forum
GA	Geneva Association
GEMU	Genuine Economic and Monetary Union
IAA	International Actuarial Association
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICS	investor compensation scheme
ICSD	Investor Compensation Schemes Directive
IFRS	International Financial Reporting Standards
IGA	intergovernmental agreement
IGD	Insurance Groups Directive
IGS	insurance guarantee scheme
IIA	Institute of Internal Auditors
IIA	Inter-Institutional Agreement
IIMG	Inter-Institutional Monitoring Group
IOSCO	International Organization of Securities Commissions
ITS	Implementing Technical Standard
JC	Joint Committee of the European Supervisory Authorities
LLR	lender of last resort
LTROs	Long-Term Refinancing Operations
MCR	Minimum Capital Requirement
MiFID	Markets in Financial Instruments Directive

MIP	Macroeconomic Imbalances Procedure
MMLR	market maker of last resort
MOU	memorandum of understanding
MtM	Micro to Macro Approach
NBER	National Bureau of Economic Research
NCA	National Competent Authority
OMTs	Outright Monetary Transactions
ORSA	Own Risk and Solvency Assessment
PRA	Prudential Regulation Authority
RTS	Regulatory Technical Standard
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SGP	Stability and Growth Pact
SMP	Securities Market Programme
SPV	special purpose vehicle
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRP	Supervisory Review Process
SSM	Single Supervisory Mechanism
TEC	Treaty establishing the European Community
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TINA	there is no alternative
TSCG	Treaty on Stability, Coordination and Governance in Economic and Monetary Union
VaR	value at risk

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Chapter 1
Introduction

The twentieth century has ushered in an era of increasing economic globalization and concomitant worldwide financial integration. The growing economic and financial interdependence of the world's economies brought into existence by that process required nation states to shift away from their previously prevailing purely domestic way of thinking and establish ever-more integrated and sophisticated international economic, financial, and political cooperation mechanisms to ensure growth and prosperity in their respective countries. In Europe, this necessity propelled the conclusion of the Treaty of Rome in 1957, which officially marked the beginning of large-scale European integration and, among other things, initiated the creation of a common European market—a construct that has since then evolved into an intrinsic part of European citizens' life.

The development of a vital section of that common market—namely the single market in insurance services—has begun in the 1970s with the first generation insurance directives' attempt to eliminate some of the obstacles hindering cross-border competition on the fragmented European insurance markets. Other pieces of EU legislation of gradually widening scope have followed suit, progressively uniting those markets and delineating the contours of the contemporary insurance regulatory and supervisory arrangements adopted under the *Solvency II* regime—the EU's new insurance regulatory framework becoming effective on 1 January 2016. This continuous integration process created favorable conditions for the emergence of large, cross-border insurance groups, which have been rapidly spreading and now dominate the European single market in insurance services. For a number of reasons to be discovered later, these groups have been the source of considerable supervisory challenges, demanding a significant amount of energy on the part of European policymakers to shape insurance regulation and supervision so as to provide for optimal solutions.

This work takes up the *Group Support Regime*—an immensely controversial and ultimately abandoned item of the Solvency II project's innovative, new group supervisory framework—which has been designed to tackle the problems stemming

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from the different regulatory treatment of international insurance groups depending on their specific organizational model. Such groups—and this designation should be understood in an economic rather than legal sense—may take a wide range of differing organizational forms entailing fundamentally divergent legal implications. The two extremes of that spectrum are groups operated in a centralized fashion usually consisting of a single enterprise and its integrated branches, and their decentralized peers comprising several legally independent subsidiaries controlled by a parent undertaking likewise constituting a distinct legal entity. While groups pertaining to the former class are largely free to allocate capital resources in line with their specific business needs, those forming part of the second category face various constraints in this respect by reason of the legal separation of their constituent companies. Yet, the ease of capital allocation is merely one of many factors based on which groups determine their organizational model, and those aspects combined may still warrant the choice of the parent-subsidiary structure. Therefore, decentralized groups resort to a broad variety of intra-group transactions to work around legal restrictions and achieve a degree of freedom in capital allocation comparable to centralized groups. This practice tends to result in complex intra-group relationships and group structures that are difficult to manage and supervise, and is thus equally inconvenient for both supervisors and supervised entities. The Group Support Regime would have alleviated these complications by providing for a relatively simple and transparent capital management tool allowing for reasonably unrestricted intra-group capital flow in groups operating in the parent-subsidiary model. Despite its uncontested merits and the admittedly pressing need to implement such an instrument in practice, the Group Support Regime was not incorporated in the Solvency II Directive due to the prevailing conviction that a supportive regulatory framework ensuring its safe functioning was not yet in place at the time.

As it turned out after the eruption of the 2007 global economic and financial crisis, the EU's wider financial supervisory and economic governance framework has been missing a lot more than that. In fact, the crisis—which is unequivocally deemed the worst financial shock since the Great Depression—has revealed massive shortcomings in the worldwide financial system. While surely no one expected difficulties of such magnitude, the crisis has not come out of the blue. Ominous signs sent out by the financial turmoils of the past roughly three decades have long indicated that the global financial system was not apt to handle the challenges posed by the increasingly integrated financial marketplace, prompting academia, policymakers, and various European and international fora to reassess the vices and virtues of different financial supervisory approaches and broader financial stability frameworks employed across the world, and develop new approaches to better accommodate emerging trends. Much effort has been spent on, *inter alia*, optimizing the structure and governance of financial stability frameworks, leading to a visible financial regulatory consolidation in many jurisdictions. While welcoming these endeavors, a relatively new, valuable, and continuously expanding research line in economics, focusing on the impact of supervisory architecture and governance on countries' financial and economic resilience, highlighted the

limits of these approaches. Masciandaro et al. even showed that modifications in financial supervisory structures and governance arrangements were negatively correlated with economic resilience during the latest economic and financial crisis.[1] That research provided clear evidence that optimal regulatory and supervisory architecture and governance—insofar as they are conceivable at all—are but an essential prerequisite of successful financial stability frameworks, and a number of other factors play an equally if not more important role in this regard.

In Europe specifically, the center of current academic and policy attention rests on the ongoing overhaul of the European Economic and Monetary Union's economic and political governance framework with a view to remedy the numerous and substantial flaws identified in the Maastricht architecture by the European financial and sovereign debt crisis. A prominent part of the progressing work focuses on the further elaboration and implementation of a comprehensive legislative agenda put forward by the European Council and Commission known under the label of *Genuine Economic and Monetary Union*, which pursues the ambitious, from an economic perspective absolutely necessary but to date politically hardly realistic objective to gradually transform the EU into a genuine fiscal federation. Indeed, the lessons learned form the crisis buttressed by the fact that the EU does not constitute an optimum currency area provide economically compelling arguments for pushing the Economic and Monetary Union forward on the path of economic and political integration and equip it with a robust, federal fiscal and political governance framework comparable to those typically employed by mature fiscal unions. Of particular importance for the present purposes is in this respect the recent implementation of the *Banking Union*—the first building block of that package—which brings a number of notable improvements to the EU's banking regulatory framework that, if adopted in the insurance sector, could create the majority of the previously missing prerequisites for the Group Support Regime's adoption.

Therefore—drawing on both relevant economic and legal literature and the ongoing work in several European and international organizations—the author proposes a state-of-the-art reform of the European financial stability framework with the twofold goal of enhancing the EU's economic resilience in anticipation of future financial crises and establish the preconditions for the application of the much-needed Group Support Regime in the insurance sector, thereby tackling an important problem in contemporary insurance group supervision. It is hoped that the recommended reform measures will find their way into the current academic and policy debates on these issues and serve as useful starting points for policy-makers' decisions on the future shape of the EU's insurance and wider financial regulatory framework. A secondary objective is to provide a helpful overview of key developments and the so far rather scarce academic literature in the areas addressed to facilitate the work of parties interested in further research in, or simply just wishing to acquire deeper knowledge on this intensely interesting and policy-relevant subject.

[1] Masciandaro et al. (2013) [1].

With these intentions in mind, the present study is structured as follows. The first two chapters give general background information on European insurance regulation and financial services legislation to illustrate the process leading up to the genesis of the Solvency II project and put in context the objectives pursued by it. Given that none of the following discussions involve aspects specific to either insurance or reinsurance undertakings, both segments of the insurance industry shall be referred to under the common denomination *insurance* throughout this study. Chapter 2 starts by giving a concise, chronological overview of the main landmarks of European insurance regulation that contributed to the establishment of the single market in insurance services up to and including the Solvency II regime. After describing the most salient achievements of the three generations of insurance directives—which laid down the foundations of that common European insurance market—the chapter discusses the respective merits and flaws of the soon-to-be-replaced *Solvency I* regime, introduces the most important stakeholders and different phases of the Solvency II project, and concludes by outlining the principal features of Solvency II.

Chapter 3 then sheds some light on the significant changes the broader European financial services legislation has undergone over the past approximately two decades, furnishing the necessary information to understand the peculiar four-level structure of the Solvency II project and the functioning of the respective levels. The *Lamfalussy financial services architecture* introducing the aforementioned four-level structure has substantially improved and accelerated the until then fairly slow and rigid European financial legislative procedure, enabling it to keep pace with rapidly changing financial market conditions. Later, the original form of the Lamfalussy process—most notably Level 2 of the framework—was amended by the Lisbon Treaty and the establishment of the *European System of Financial Supervision*. Besides the European System of Central Banks and the recently drawn-up Banking Union, this new supervisory system forms the core of the currently existing European financial stability framework, and thus also the basis of the reform proposals presented at the end of this survey. For this reason, the chapter describes these modifications and the emerging new Lamfalussy arrangements in detail.

Chapter 4 narrows down the focus to matters related to insurance group supervision. Taking account of the cause-effect relationship between financial market developments and the adopted regulatory and supervisory practices to accommodate them, this chapter defines what insurance groups are and elaborates on their evolution and significance in the insurance industry, before delving into the specifics of the respective regulatory and supervisory approaches adopted towards them. Beginning by the introduction of the wider notion *business group*, it derives the narrower definition of insurance group used by the Solvency II Directive. Subsequently, it analyzes the characteristics of the various organizational forms available for insurance and other financial groups along with the supervisory challenges they present, and highlights the main factors determining groups' choice of model. The chapter then turns to reviewing insurance groups' growing role on the European insurance markets and the increasingly sophisticated group supervisory frameworks introduced by EU legislation—particularly the Insurance Groups Directive—over

time. The central subject-matter of the chapter is the detailed introduction of the Solvency II Directive's advanced group supervisory rules.

While acknowledging the extraordinary worthiness of the upcoming group supervisory framework, Chap. 5 turns the reader's attention to a widely regretted caveat of that system—notably the omission of the Group Support Regime from the Solvency II Directive. Recalling the fundamental differences between centralized and decentralized groups, it illustrates the pivotal importance of unrestricted intra-group capital flow for realizing the economic benefits of operating in a group structure, and accentuates how the Group Support Regime could have contributed to ameliorating the problems groups opting for the parent-subsidiary structure face in this respect. This introductory part of the chapter is followed by a thorough description of the provisions on the Group Support Regime as set forth in the Commission's latest proposal[2] for the Solvency II Directive, with extensive comments aiming to explain the regulatory intention followed by those rules. These theoretic considerations are then shored up with a series of case studies to show how this proposed, innovative capital management tool would work in practice. In conclusion, the chapter reviews the reasons that led to the Group Support Regime's rejection, introduces the *provisions concerning the supervision of group solvency for groups with centralized risk management*, which have instead been inserted in the Solvency II Directive by virtue of a compromise reached between Member States on this issue, and outlines recent developments in European financial supervision—in particular those brought by the establishment of the European System of Financial Supervision and the Banking Union—that could warrant a revision of the negative stance taken towards the Group Support Regime.

With the primary goal to introduce the Banking Union arrangements, Chap. 6 takes a wider perspective and explains a number of predominantly economic aspects relevant in this context. As mentioned earlier, Banking Union is the first pillar of the Commission's and Council's Genuine Economic and Monetary Union agenda, which, in turn, aims to equip the Economic and Monetary Union with an economic and political governance framework comparable to those in place in mature fiscal federations. But why should the Economic and Monetary Union be transformed into a fiscal federation? Many maintain that the EU has enough problems as it is due to the interconnectedness of its culturally, economically, and politically so profoundly different Member States, so why make matters even worse by further integrating them? We barely made it out of this crisis—in fact, it might not even be over—and yet we want to provoke another? While under the current—hopefully post-crisis—circumstances these are fairly understandable and legitimate questions, they reflect a rather one-sided and pessimistic perception of economic integration. To ease such skepticism, reviewing the international economic literature on economic integration, optimal currency area theory, and fiscal federalism, the chapter enlightens the reader why a move towards fiscal federalism is economically justified. It then corroborates those deliberations by elaborating a few key features of successful

[2] COM(2008) 119 final [2].

monetary unions (which are at the same time also fiscal federations) and contrasting the Economic and Monetary Union's economic and political governance framework to those arrangements in order to highlight the former's inherent weaknesses. To further emphasize this point and also to illustrate the circumstances that prompted the Genuine Economic and Monetary Union initiative, the chapter examines how those flaws aggravated the crisis and hampered crisis resolution efforts. The chapter concludes by introducing all four building blocks of the Genuine Economic and Monetary Union package. In line with its heightened relevance for present purposes, the greatest attention is dedicated to the rules constituting the Banking Union, but both for the sake of completeness and on account of their mutual interdependence, the remaining three pillars known as *Fiscal Union*, *Economic Union*, and *Political Union* shall also be briefly presented.

Building on the information provided in previous chapters, Chap. 7 puts forward recommendations regarding a possible reform of the European financial stability framework with the dual objective to strengthen its resilience against future financial crises and create the prerequisites for the Group Support Regime's safe functioning in the insurance sector. Even though those reform considerations were originally merely driven by the latter, insurance-specific intention, this broader approach is warranted in light of the results furnished by recent research on financial regulation and supervision. As previously remarked, for better or worse, the global financial marketplace has become significantly more integrated over the past few decades and the thereby raised challenges stimulated considerable intellectual debate on the optimality of financial supervisory approaches and wider financial stability frameworks employed around the world. While the success and failure of the various arrangements used in different jurisdictions clearly shows that the search for a one-size-fits-all solution is pointless, certain generally appreciated financial regulatory and supervisory goals, trends, and practices have crystallized as a consequence of the continuous efforts to adapt financial stability frameworks to changing financial market realities. As a starting point for further reflections on the successively proposed reform measures, the chapter gives an overview of the main objectives and tools of financial regulation as well as the most commonly used financial supervisory approaches and the advantages and disadvantages associated with them. After drawing attention both on the limitations of the endeavors to optimize regulatory structures and on other key determinants of supervisory success, it gathers a few customarily accepted characteristics of well-functioning financial stability frameworks, and introduces the European financial stability framework currently in use. Following the path started by the Banking Union arrangements, the chapter then proposes to complement the European financial supervisory architecture with an *Insurance Union* and a *Securities Union*. To this end, it defines various reform objectives and policy options to achieve those objectives, and introduces the methodology based on which the chosen policy options are subsequently evaluated. The chapter continues by analyzing and comparing the different policy options, setting out specific reform measures based on the result of the foregoing analysis, and introducing the thereby emerging possible new European financial stability framework. It finishes with a few summarizing concluding remarks on the suggested

new framework including, *inter alia* its implications with regard to the adoption of the Group Support Regime.

And finally, Chap. 8 briefly revisits the core topics discussed throughout this work, outlines just a handful of many possible, interesting open research directions in the fields addressed, and concludes with some closing reflections to take with us for the future.

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Chapter 2
Milestones of European Insurance Regulation

Concluding the Treaty of Rome back in 1957, European Member States have set themselves the ambitious goal of establishing a common European market to promote economic development in the *European Economic Community (EEC)* brought into existence by the same treaty.[1] This chapter centers on the introduction of the single market in financial services, which consists of the banking, insurance, and securities sectors and forms an important segment of the broader European internal market guaranteeing the so called *four freedoms*, i.e., free movement of goods, persons, services, and capital.[2] Given the highly extensive nature of the topic and with insurance group supervision being the present dissertation's core area of examination, the scope of this chapter is restricted to the introduction of the major landmarks of European insurance regulation, which have gradually transformed the initially fragmented national regulatory arrangements into a consistent set of rules, thereby creating a single market in the area of insurance.

The chapter starts by an outline of the three generations of insurance directives, which have ushered in the integration of the European insurance industry. It then briefly addresses the main merits and shortcomings of the first review of the thereby created European insurance regulatory framework known as *Solvency I*. The chapter concludes with a detailed discussion of the considerations prompting a more fundamental reform of that regime and the introduction of the key features

[1]The Treaty of Rome was repeatedly renumbered and otherwise amended by subsequent EU treaties. The original Treaty and its various versions are referred to as the *Treaty establishing the European Community (TEC)* in line with the EEC's renaming in *European Community (EC)* by the *Treaty on European Union (TEU)* signed in Maastricht in 1993. In 1997, the Treaty of Amsterdam renamed, modified, and consolidated both treaties, while the Lisbon Treaty signed in 2007, amidst other amendments to TEU and TEC, renamed the latter into the *Treaty on the Functioning of the European Union (TFEU)*. Against this backdrop, provisions of TEU and TFEU (hereinafter also referred to as the *Treaty* or *Treaties*) shall be cited within this work in accordance with their latest consolidated versions [26] following the amendments made by the Lisbon Treaty.

[2]See Article 3(3) TEU and Articles 26 et seq. TFEU.

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of *Solvency II*, the EU's new, state-of-the-art insurance regulatory framework applicable as of 1 January 2016.

2.1 Three Generations of Insurance Directives

Back in the time of the EEC's genesis, the notion of a single European insurance market was nothing but a fragile vision. In reality, insurance companies writing business in Europe were confronted with very different, strictly regulated national legal systems and had to struggle through myriads of restrictions mostly having the single purpose of impeding the market access of foreign insurers. Neither fair competition among insurers nor a sufficient level of consumer protection—the ultimate objective of any insurance legislation—was conceivable under those unfavorable conditions, making the European insurance markets everything but attractive for insurance companies registered abroad. These difficulties stemming from Europe's multi-jurisdictional character added a further dimension to the economic rationals advanced by public interest theory calling for the regulation of the imperfect insurance market.[3] Thus, Europe was badly in need of a single insurance market. Achieving this ambitious, yet absolutely essential goal, in turn, presupposed the creation of a uniform European insurance regulatory framework requiring the deregulation and liberalization[4] of the then highly fragmented European insurance market. This decades-long and arduous process culminating in the soon-to-be-operational Solvency II project was gradually achieved by a bewildering wealth of EU legislation shaped by vivid legal and political debates among a wide group of different affected stakeholders. Seeing as an in-depth introduction of all those measures would exceed the limits of this study, the present section will only briefly address the three generations of insurance directives, which constitute the most important landmarks in the extensive legislative enterprise that brought about the nucleus of the European insurance solvency framework sometimes referred to as *Solvency 0*.[5]

2.1.1 *First Generation Insurance Directives*

The first generation insurance directives[6] were adopted in the 1970s and ensured a limited freedom of establishment in conformity with the so called *host country*

[3] Klein (1995) [12], Eling et al. (2007) [7], and Doff (2008) [3].

[4] Very instructive on the concepts of deregulation and liberalization: Sterzynski (2003) [21], p. 44.

[5] For more information see Pool (1990) [102] and Sandström (2005) [18], p. 15 et seq.

[6] Directive 73/239/EEC [32] (hereinafter referred to as the *First Non Life Directive*) and Directive 79/267/EEC [33] (hereinafter referred to as the *First Life Directive*).

control principle[7]. This principle allowed European insurers the taking up of insurance business within the territory of another Member State by establishing a head office, agency, or branch with prior authorization of the competent authorities of the host Member State. *European* pursuant to the definition used by the Treaty are 'companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community.'[8] As such permissions were only granted on the condition that insurers of other Member States fulfill certain requirements[9], which tended to be stronger compared to those applicable to their local competitors, this practice soon became an obstacle rather than a driving force of the market integration process.

2.1.2 Second Generation Insurance Directives

The second generation insurance directives[10] introduced in 1988 and 1990 made one step further in the liberalization process. They brought an important new guarantee, notably the freedom of services, which enabled insurers to provide their services in foreign Member States without actually having an establishment in the host Member State. This implied that these insurers were only subject to supervision by their home countries, while host Member States had no control over them. The allocation of all supervisory powers to the home countries' authorities, however, raised considerable anxiety among Member States as to the level of protection granted to their consumers, leading many of them to maintain the host country control principle where consumers were involved. Consequently, the directives differentiated between private and company business with only the latter falling under the new regime. Another important restriction of the freedom of services resulted from the distinction between large and small risks and a correspondent allocation of supervisory competences.[11]

2.1.3 Third Generation Insurance Directives

Despite some remaining imperfections, the creation of the basic legal framework necessary for the functioning of the European single market in insurance services

[7] See Article 6 of the First Non Life and Life Directives.

[8] Article 54 TFEU.

[9] See Articles 7 et seq. of the First Non Life and Life Directives.

[10] Directive 88/357/EEC [34] (hereinafter referred to as the *Second Non Life Directive*) and Directive 90/619/EEC [28] (hereinafter referred to as the *Second Life Directive*).

[11] See the preamble of the Second Non Life and Life Directives.