MFSA

MALTA FINANCIAL SERVICES AUTHORITY

INSURANCE AND PENSIONS SUPERVISION UNIT

Guidance Note

Solvency requirements in relation to Protected Cell Companies

December 2013

Contents

1. Explanatory Note

This guidance note is being circulated by the MFSA as a follow up to the MFSA Guidance Notes circulated in May 2011 and December 2012. This note now clarifies the solvency requirements for PCCs under Solvency I under different scenarios pending Solvency II implementation.

2. Purpose

The purpose of this guidance note is to set out the treatment of PCCs under Solvency II. The focus of this guidance paper will be on the calculation of the Solvency Capital Requirement (SCR) and the adjustment to the Own Funds. This guidance note also makes reference to the presence of diversification within PCCs.

This guidance note reflects the latest developments included in the updated Technical Specifications for the Solvency II valuation and Solvency Capital Requirements calculations (Part I) as distributed by EIOPA on the 18th of October 2012.

It is important to stress that the updated Technical Specifications for the Solvency II valuation is still a working document and hence it is possible that further changes could take place in future. For the purpose of this document, the updated Technical Specifications for the Solvency II valuation and Solvency Capital Requirements calculations (Part I) as distributed by EIOPA on the 18th of October 2012 shall be referred to as “Updated Technical Specifications (Part I)”.

3. PCC Structure

A PCC is a type of company authorised in terms of the Insurance Business Act (Cap 403) (‘the Act’) and the Companies Act (Cell Companies Carrying on Business of Insurance) Regulations, 2010 (‘the Regulations’).

A PCC is a single legal entity. It is structured in two parts namely, a non-cellular part (the core) and an unlimited number of cells. Despite the segregation of assets and liabilities that exists between protected cells and the core and among the protected cells themselves, a cell has no separate legal identity.

Within a PCC structure, the cells are approved to write insurance and/or reinsurance business. The core may or may not be authorised to write insurance and/or reinsurance business. The core maintains and controls all the activities of the PCC.

For regulatory purposes, where any liability arising is attributable to a cell of the PCC:

- The cellular assets of a cell will be primarily used to meet the liability of that cell;
- The non-cellular assets (also known as the core assets) can be utilized to meet the liability of the cell, only when the cellular assets of the cell have been exhausted;
- Cellular assets from other cells cannot be used to meet the liability of the cell.

There are many possible structures for the setting up of a PCC. The two most common types of PCC structures that can exist are:

Type 1	In a typical PCC structure, the core does not write any insurance or reinsurance business.
Type 2	The core and the cells write insurance and/or reinsurance business. The cell shall write all or a subset of the classes of insurance business underwritten by the core.

In both types of structures, the core of the PCC is the provider of capital for solvency purposes. In the event that any of the cells become insolvent, the core should transfer capital to meet the liabilities of the cell.

The pursuit of life and non-life business is only permitted in accordance with Article 73 of the Directive 2009/138/EC.

The Regulations also provide for non-recourse agreements. As per Regulation 15 (1) Companies Act (Cell Companies Carrying on Business of Insurance) Regulations (L.N. 243 of 2010), where a cell <u>exclusively</u> carries on business of affiliated insurance and/or business of reinsurance, the company may, by specific written agreement to that effect, provide that only the cellular assets of that cell may be utilized to satisfy the cellular liability of such cell. A non-recourse agreement is put in place to protect the core from the creditors of the cells; otherwise a creditor can pursue core assets to the disadvantage of other cells.

4. Solvency requirements for PCCs under Solvency I

Pending Solvency II implementation, the PCC as a whole is required to be capitalised at the higher of the sum of 1.5 times required margin of solvency of individual cells or the minimum guarantee fund. Capital may be deposited in the core or in both the core and the cells. Cells may or may not have cell capital. Where cells are not capitalised, or not sufficiently capitalised, core capital shall be sufficient to cover any solvency deficit of the individual cells.

Subject that:

- where within a PCC structure there exists cells with non-recourse to the core, such cells shall be capitalised at 1.5 times their required margin of solvency;
- where within a PCC structure there is an underwriting core, then the core and all cells shall each be capitalised at 1.5 times their respective required margin of solvency;
- where the minimum guarantee fund is higher than the sum of 1.5 times the required margin of solvency of individual cells and if applicable the core (in the case of an underwriting core), the difference may be deposited in the core and/or the individual cells.

For the purpose of calculating the required margin of solvency, for individual cells or the core, reference should be made to the Insurance Business (Assets and Liabilities) Regulations, 2007 without applying the provisions of the Minimum Guarantee Fund.

It should be clarified that this note provides guidance in relation to the requirements of the MFSA for establishing the solvency requirements for PCCs under Solvency I. It does not seek to interpret relevant legislation and promoters are encouraged to contact the MFSA to arrange a preliminary meeting to outline and discuss any proposal prior to formalising an application.

5. An introduction to Solvency II and PCCs

Whilst Solvency I is a rules based system for calculating risks and capital requirements, Solvency II introduces a comprehensive framework for risk management for defining required capital levels and to implement procedures to identify, measure, and manage risk levels.

The Solvency II Pillar 1 framework sets out qualitative and quantitative requirements for calculation of technical provisions and the Solvency Capital Requirement (SCR) using either a standard formula or an internal model developed by the (re)insurance company. Technical provisions represent the current amount an (re)insurance company would have to pay for an immediate transfer of its obligations to a third party. The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. In addition to the SCR, the Minimum Capital Requirement (MCR) must be calculated. The MCR represents the minimum level below which the amount of financial resources should not fall. The breach of both the SCR and the MCR results in supervisory action. However, the breach of the MCR will result in the authorization of the (re)insurance undertaking to be withdrawn unless it is able to re-establish the MCR within a short period of time as determined by Solvency II legislation.

As Solvency II requires a holistic approach to the risk based solvency approach, this presents challenges to the PCC setup.

The Updated Technical Specification (Part I) prescribes that PCCs shall be considered as a type of arrangement that give rise to ring-fenced funds. The following has been extracted from Annex U of the aforementioned technical specifications:

> *Annex U – Examples for types of arrangement that give rise to ring-fenced funds according to national or EU legislation*
>
> *National Legislation:*
>
> *(ii) In some member states legislation creates companies which comprise individual cells (protected cell companies). Although together they comprise a single legal entity, the cells operate as distinct units on both a going and gone concern basis. One cell cannot be called upon to support the liabilities of another, or of the undertaking as a whole. The assets of the general account or core are not normally available to meet liabilities of individual cells. However, the general account may in some cases be relied on to support an individual cell provided that the assets attributable to the relevant cell have been exhausted.*

SCR 10.3 of the Updated Technical Specifications (Part I) provides the defining characteristics of a ring-fenced fund.

For the remainder of this document, the "ring-fenced fund" has been equated to the "cell" and the "rest of the undertaking" has been equated to the "core".

6. Calculation of notional Solvency Capital Requirements (nSCR) under Solvency II

For PCCs, the notional SCR (nSCR) has to be calculated for each cell as well as the core, in the same manner as if they were all separate undertakings. This can be done using either the standard formula, Undertaking Specific Parameters (USPs) or an internal model (full or partial).

In the case where the capital requirement is calculated using the standard formula, the nSCR of a cell is derived by applying the standard formula to those assets and liabilities within the cell as if it were a separate undertaking.

Where multiple cells within the PCC structure exhibit similar characteristics, the calculation methodology applied to one cell may also be applied to any similar cell, provided the methodology produces sufficiently accurate results for all of the similar cells.

The nSCR for each cell is determined by aggregating the capital requirements for each sub-module and risk module of the basic SCR using the procedure for aggregation of the standard formula prescribed by Articles 104 of Directive 2009/138/EC. This means that diversification between risk modules and sub-module *within* a cell or a core is permitted.

The calculation of the nSCR of a cell with the internal model has to be consistent with the calculation of the SCR for the PCC as a whole.

The SCR for the PCC as a whole is the sum of the notional SCR (nSCR) for each cell and the nSCR of the core.

$$SCR_{PCC} = nSCR_{Core} + nSCR_{Cell1} + nSCR_{Cell2} + \cdots + nSCR_{Celln}$$

No diversification benefits among cells and/or between cells and the core are reflected in the calculation other than in respect of PCCs under Article 304[1] of Directive 2009/138/EC and where conditions specified in that Article are met.

Any negative nSCR is set to zero before being aggregated with any positive nSCR of the cells and the core.

7. Materiality

SCR10.2 of the Updated Technical Specifications (Part I) states that when a ring-fenced fund is not material, the undertaking may exclude the total amount of restricted own-fund items from the amount of own-fund items eligible to cover the SCR and the amount of basic own fund items eligible to cover the MCR. In this case the undertaking does *not* have to calculate the nSCR.

The materiality of a ring-fenced fund shall be assessed based on the following conditions:

(i) The nature of the risks arising from or covered by the ring-fenced fund

(ii) The amount of restricted own funds within the ring-fenced fund and the volatility of those amounts over time

(iii) The proportion of the undertaking's total assets it represents, alone or combined with other ring-fenced funds

[1] *Please refer to the Appendix for Article 304 of the Solvency II Directive.*

(iv) The proportion of the undertaking's capital requirement it represents, alone or combined with other ring-fenced funds

(v) The nature of the assets and liabilities within the ring-fenced fund

(vi) Whether a separate notional SCR should be required in any event owing to its likely impact on the calculation of the SCR of the undertaking as a whole under the standard formula

Any ring-fenced fund which arises through the operation of EU law is always regarded as material.

These requirements shall be similarly applied to the cells within the PCC structure.

8. The treatment of Restricted Own Funds in the PCC Structure

For each cell within the PCC, the own funds are restricted as the assets over liabilities and subordinated liabilities within each cell cannot be transferred to cover all types of losses within the core and any other cells.

To determine if the restricted own funds within a cell exceed the nSCR, first compare the restricted own funds and the nSCR for each cell. The following table summarises the scenarios that may arise as prescribed in the Updated Technical Specifications (Part I).

Scenario	**Restricted own funds > Notional SCR**	**Restricted own funds <= Notional SCR**
Surplus/Deficit arising from cell	Surplus	Deficit
Adjustment to total own funds	Y	N
	Total own funds = Own fund (core) + nSCR (cell$_1$) + nSCR (cell$_2$) Total SCR = nSCR (core) + nSCR (cell$_1$) + nSCR (cell$_2$) + … + nSCR(cell$_n$) Where the restricted own funds of the cell is greater than the nSCR of the cell, then the restricted own funds will be reduced to the nSCR in the calculation of the total own funds of the PCC	Total own funds = Own fund (core) + Own fund (cell$_1$) + Own fund (cell$_2$) Total SCR = nSCR (core) +nSCR (cell$_1$) + nSCR (cell$_2$) +…+nSCR(cell$_n$) Where the restricted own funds of the cell is less than the nSCR of the cell, then the restricted own funds for each cell will remain unadjusted and added to the total own funds of the PCC

If the amount of the restricted own funds within the cell is less than the nSCR, the PCC will not be in compliance with the SCR of the PCC as a whole unless the total of own funds within the core and the restricted own funds within the cells combined are sufficient to cover that SCR.

In the case where there is a non-recourse agreement (i.e. the cell cannot obtain capital from the core), then the cell must have sufficient own funds to cover its nSCR at all times.

Also, an adjustment to the reconciliation reserve is required for restricted own fund items in the cell and the core, whereby the reconciliation reserve is reduced by the amount that the restricted own fund items exceeds the nSCR.

9. Tier capital classification

In terms of Solvency I, the available solvency margin shall consist of the following:

(a) paid-up share capital;

(b) reserves (statutory and free) not corresponding to underwriting liabilities;

(c) the profit or loss brought forward after deduction of dividends to be paid;

(d) profit reserves appearing in the balance sheet where they may be used to cover any losses which may arise and where they have not been made available for distribution to policy holders;

(e) cumulative preferential share capital and subordinated loan capital up to 50 % of the lesser of the available solvency margin and the required solvency margin, no more than 25 % of which shall consist of subordinated loans with a fixed maturity, or fixed-term cumulative preferential share capital;

(f) securities with no specified maturity date and other instruments, including cumulative preferential shares other than those mentioned above, up to 50 % of the lesser of the available solvency margin and the required solvency margin for the total of such securities and the subordinated loan capital referred to above;

(g) the difference between a non-Zillmerised mathematical provision and a mathematical provision Zillmerised at a rate equal to the loading for acquisition costs included in the premium;

(h) hidden net reserves arising out of the valuation of assets, in so far as such hidden net reserves are not of an exceptional nature;

(i) one half of the unpaid share capital or initial fund, once the paid-up part amounts to 25 % of that share capital or fund, up to 50 % of the lesser of the available and required solvency margin;

(j) The available solvency margin shall be reduced by the amount of own shares directly held by the assurance undertaking.

All types of own funds are considered equal although some can only be used up to a certain extent.

According to the QIS 5 Technical Specifications dated 5th July 2010, own funds used to meet the notional SCR for the cells would be recognised as Tier 1 eligible own funds. If a cell does not have sufficient own funds to meet its nSCR, then the own funds which meet any part of the notional SCR may nonetheless be recognized as Tier 1 eligible own funds in meeting the SCR for the undertaking as a whole.

This requirement has been removed from the Updated Technical Specifications (Part I).This means that the usual tiering of capital shall be applied to the cells and the core within the PCC structure.

For Solvency II purposes, the own funds are divided into basic own funds and ancillary own funds which are further classified into three tiers as prescribed in the Updated Technical Specifications (Part I).

Unrestricted Tier 1 Basic own-funds include funds such as:

(i) paid-in ordinary share capital and the related share premium account

(ii) paid-in initial funds, members' contributions or the equivalent basic own-fund item for mutual and mutual-type undertakings

(iii) a reconciliation reserve

(iv) surplus funds that fall under Article 91(2) of Directive 2009/138/EC

Restricted Tier 1 Basic own-funds include funds that comply with the laws, regulations and administrative provisions adopted pursuant to Directive 2002/83/EC[2], Directive 73/239/EEC[3] and Directive 2005/68/EC[4] and do not fulfil the criteria for unrestricted Tier 1 are classified as restricted Tier 1 provided they:

(i) rank after the claims of all policy holders and beneficiaries and non-subordinated creditors

(ii) are fully paid-up

(iii) have no specified maturity

(iv) are only repayable or redeemable at the option of the insurance or reinsurance undertaking and repayment or redemption of the basic own-fund item is subject to prior review by the supervisory authority

(v) allow the undertaking to cancel or defer the payment of interest or dividends in relation to that item

(vi) provide for the loss-absorption capacity of the item, while enabling the insurance or reinsurance undertaking to continue its business

Tier 2 Basic own-funds include funds that comply with the laws, regulations and administrative provisions adopted pursuant to Directive 2002/83/EC, Directive 73/239/EEC and Directive 2005/68/EC and do not fulfill the criteria for unrestricted or restricted Tier 1 are classified as Tier 2.

Tier 3 Basic own-funds are made up of net deferred tax assets classified as Tier 3 basic own-fund provided the following criteria are met:
(i) The basic own-fund item does not include features which may cause the insolvency of the insurance or reinsurance undertaking or may accelerate the process of the undertaking becoming insolvent.
(ii) The basic own-fund item is free from encumbrances and is not connected with any other transaction, which when considered with the subordinated liability, could undermine the features that the item is required to possess in accordance with part (i) above.

Tier 2 Ancillary own-funds are items of capital which can be called up to absorb losses. They include unpaid share capital, letters of credit or guarantees and any other legally binding

[2] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance

[3] 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

[4] Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC

commitments received by insurance and reinsurance undertaking. These are subject to prior supervisory approval.

Tier 3 Ancillary own-funds are made up of existing arrangements currently eligible to meet solvency requirements which would constitute ancillary own funds under Solvency II, but which would not be eligible as Tier 2 ancillary own funds because that item would not be classified in Tier 1 if it were called up and paid in. These are subject to prior supervisory approval.

10. Eligibility and limits applicable to Tiers 1, 2 and 3

To meet the SCR/nSCR:

(a) the proportion of Tier 1 items must be at least 50% of the (n)SCR;

(b) the amount of Tier 3 items must be less than 15% of the (n)SCR.

Tier 2 items are eligible for covering the SCR/nSCR as long as their amount is less than 50% of the SCR/nSCR subject to the provision that the amount of eligible Tier 2 items plus the amount of eligible Tier 3 items is less than 50% of the SCR/nSCR.

Tier 3 items are eligible for covering the SCR/nSCR as long as their amount is less than 15% of the SCR/nSCR subject to the provision that the amount of eligible Tier 2 items plus the amount of eligible Tier 3 items is less than 50% of the SCR/nSCR.

To meet the MCR only Tier 1 items and Tier 2 basic own funds items are eligible. At least 80% of the MCR should be met by Tier 1 items. Tier 3 basic own fund items and ancillary own funds are not eligible for the MCR.

11. Conclusion

In conclusion,

(i) The core and the cells within the PCC structure can be treated as ring-fenced funds under Solvency II

(ii) The SCR for PCCs can be calculated using either the standard formula, USPs or internal models (full or partial).

(iii) Diversification is permitted *within* the core or any of the cells in isolation

(iv) Diversification between the cells and the core is only possible for ring-fenced funds which fall under Article 304 of Directive 2009/138/EC and where conditions specified in that Article are met.

Appendix

Article 304 - Duration-based equity risk sub-module

1. Member States may authorise life insurance undertakings providing:

(a) Occupational retirement provision business in accordance with Article 4 of Directive 2003/41/EC, or

(b) Retirement benefits paid by reference to reaching, or the expectation of reaching, retirement where the premiums paid for those benefits have a tax deduction which is authorised to policy holders in accordance with the national legislation of the Member State that has authorised the undertakings ;

Where:

(i) All assets and liabilities corresponding to the business are ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer ;

(ii) The activities of the undertaking related to points (a) and (b), in relation to which the approach referred to in this paragraph is applied, are pursued only in the Member State where the undertaking has been authorised ; and

(iii) The average duration of the liabilities corresponding to the business held by the undertaking exceeds an average of 12 years ;

To apply an equity risk sub-module of the Solvency Capital Requirement, which is calibrated using a Value-at-Risk measure, over a time period, which is consistent with the typical holding period of equity investments for the undertaking concerned, with a confidence level providing the policy holders and beneficiaries with a level of protection equivalent to that set out in Article 101, where the approach provided for in this Article is used only in respect of those assets and liabilities referred in point (i). In the calculation of the Solvency Capital Requirement those assets and liabilities shall be fully considered for the purpose of assessing the diversification effects, without prejudice to the need to safeguard the interests of policyholders and beneficiaries in other Member States.

Subject to the approval of the supervisory authorities, the approach set out in the first subparagraph shall be used only where the solvency and liquidity position as well as the strategies, processes and reporting procedures of the undertaking concerned with respect to asset-liability management are such as to ensure, on an on-going basis, that is able to hold equity investments for a period which is consistent with the typical holding period of equity investments for the undertaking concerned. The undertaking shall be able to demonstrate to the supervisory authority that that condition is verified with the level of confidence necessary to provide policyholders and beneficiaries with a level of protection equivalent to that set out in Article 101.

Insurance and reinsurance undertakings shall not revert to applying the approach set out in Article 105, except in duly justified circumstances and subject to the approval of the supervisory authorities.

2. The Commission shall submit to the European Insurance and Occupational Pensions Committee and the European Parliament, by 31 October 2015, a report on the application of the approach set out in paragraph 1 and the supervisory authorities' practices adopted pursuant to paragraph 1, accompanies, where appropriate, by adequate proposals. That report shall address, in particular, cross-border effects of the use of that approach with a view to preventing regulatory arbitrage by insurance and reinsurance undertakings.