CEIOPS

Committee of European Insurance and Occupational Pensions Supervisors

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CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles

(former Consultation Paper 36)

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1. Introduction

1.1. Background

1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence.

1.2. This document provides CEIOPS' advice for Level 2 measures with regard to Special Purpose Vehicles (SPVs), as required in Article 211 of the Solvency II Level 1 text[1] ("Level 1 text"), addressing the authorisation, regulatory requirements and scope of supervisory review that relate to the establishment of SPVs under Solvency II. It also includes material that could be considered for Level 3 guidance.

1.3. SPVs are specifically addressed in the Directive because it is recognised that appropriate rules should be provided for SPVs as they differ from traditional reinsurance undertakings. The purpose of introducing the definition of SPVs in the Directive is to allow alternatives to reinsurance contracts and reinsurance undertakings that provide 'reinsurance like' services to insurers and reinsurers. Supervisors acknowledge that there are risks inherent in using SPVs and hence an appropriate supervisory regime needs to be established to protect policyholders and to avoid systemic risks. On the other hand, SPVs can play a role in facilitating alternative risk transfer and bespoke risk management solutions that enable undertakings[2] to better align their risk profile with their risk tolerance and SPVs may provide additional reinsurance capacity at times in which cover through more traditional channels is limited. CEIOPS is therefore looking to develop a regime for SPV that protects policyholders of undertakings while at the same time not preventing innovation in the insurance industry.

1.4. The Level 1 text in Article 211 highlights five distinct areas to be addressed by way of Level 2 implementing measures, these being:

i. The scope of authorisation;

ii. Mandatory conditions to be included in contracts issued;

[1] See latest version from 19 October 2009 available at http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf

[2] The term "undertaking" is used in this advice to refer to insurance and reinsurance undertakings as a cedant that use SPVs.

iii. Governance requirements (including fit and proper requirements for shareholders and persons running the SPV and sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements);

iv. Supervisory reporting (accounting, prudential and statistical information requirements); and

v. Solvency requirements.

1.2. Scope of this Advice

1.5. It is important to note the scope of Articles 13(26) (definition of an SPV for the purposes of the Directive) and 211 (relating to the establishment of SPVs within the territory of Member States) which determine the scope of this advice. This advice deals with SPVs as defined in the Directive (see Section 3.2 below). The advice therefore does not deal with the following:

- the requirements on the best estimate liabilities for undertakings who use SPVs (per Article 81) – to be covered by Level 2 implementing measures or Level 3 guidance relating to Article 86(a) and (g)[3];

- risk management, internal control requirements and the calculation of the capital requirements, for undertakings who use SPVs – to be covered by Level 2 implementing measures or Level 3 guidance relating to Article 50 and Article 111(e)[4];

- SPVs that are established outside the European Economic Area (EEA) and used by undertakings situated in a Member State – to be covered by Level 2 implementing measures or Level 3 guidance relating to Article 172[5];

- SPVs authorised prior to the date referred to in Article 309(1)[6];

- the use of other types of vehicles established where non-insurance risks are transferred to a vehicle from an

[3] It is worth noting Recital 91 which says that recoverable amounts from a special purpose vehicle should be considered as amounts deductible under reinsurance contracts or retrocession contracts.

[4] The advice also does not deal with the requirements on the best estimate liabilities and the calculation of capital requirements for undertakings that use SPVs authorised prior to the date referred to in Article 309(1) and subject to the law of the Member State having authorised the SPV, in accordance with Article 211(3).

[5] This Article set out conditions for third-country equivalence.

[6] CEIOPS expects SPVs established between now and the implementation of Solvency 2 to have regard to the principles of the new regime.

undertaking[7] – to be covered by Level 2 implementing measures or Level 3 guidance relating to Article 86 (a) and (g) and Article 111 (e) as defined in Article 13(36); and

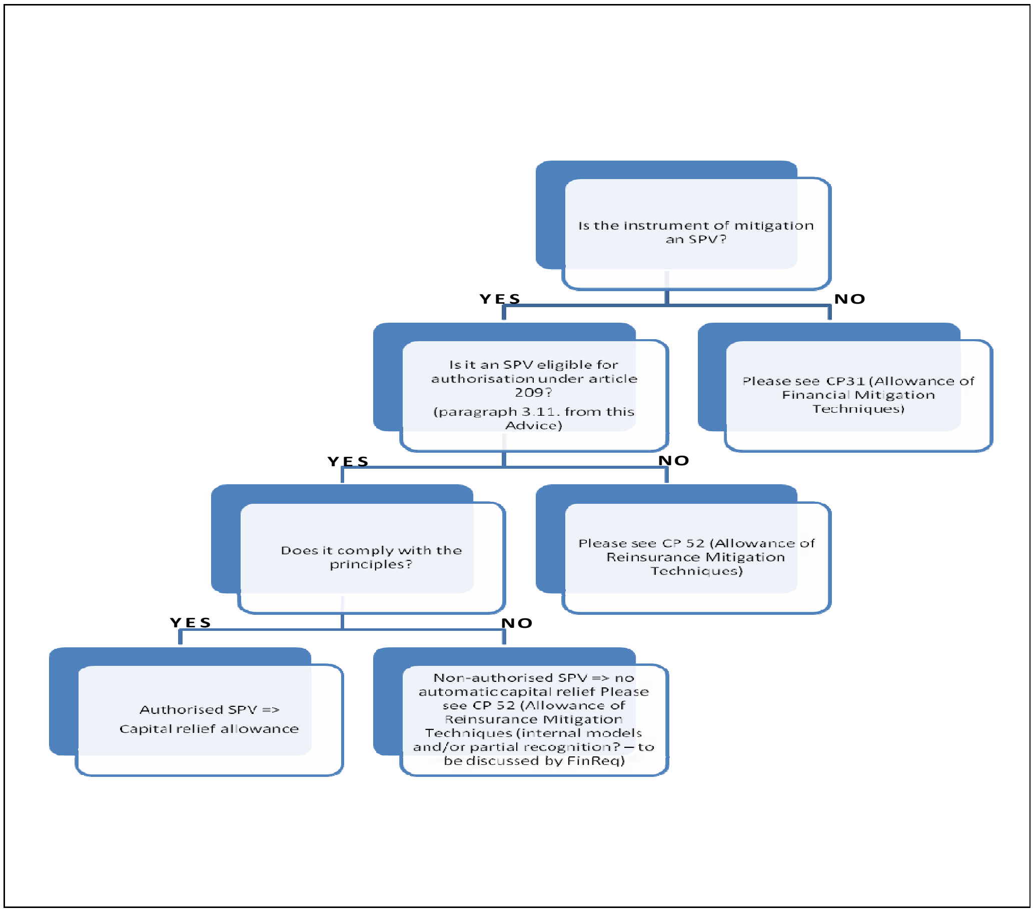
- other forms of risk mitigation which could also provide relief against capital requirements to the extent that risk is transferred to a counterparty[8] – to be covered by Level 2 implementing measures or Level 3 guidance relating to Article 111(e).

1.6. To assist in understanding the scope of the advice in this paper in relation to work on other risk mitigation techniques that CEIOPS produced (CEIOPS' Level 2 Advice on SCR Standard Formula – Allowance for Financial Mitigation Techniques and CEIOPS' Level 2 Advice on SCR Standard Formula – Reinsurance Mitigation)[9], the following diagram establishes where various risk mitigation techniques have been covered:

[7] These risk mitigation tools could be labelled as "SPVs" but are not considered as such for the purposes of the Directive according to the definition of Article 13(26) and are therefore not included in the authorisation process set out in Article 211. Article 13(36) defines a risk mitigation tool as *"all techniques, which enable insurance and reinsurance undertakings to transfer part or all of their risks to another party"*.

[8] The transfer of a risk to a counterparty is often accompanied by the introduction of a new risk (e.g. counterparty risk) which would need full consideration.

[9] See CEIOPS-DOC-26/09 at http://www.ceiops.eu/index.php?option=content&task=view&id=579 and CEIOPS-DOC-54/09 at http://www.ceiops.eu/index.php?option=content&task=view&id=603



1.7. Some details on the above areas may be included within the advice for completeness.

2. Extract from Level 1 Text

2.1. Article 211 (Special purpose vehicle) of the Level 1 text reads:

1. Member States shall allow the establishment within their territory of special purpose vehicles, subject to prior supervisory approval.

2. In order to ensure a harmonised approach with respect to special purpose vehicles, the Commission shall adopt implementing measures laying down the following:

(a) the scope of authorisation;

(b) mandatory conditions to be included in all contracts issued;

(c) fit and proper requirements as referred to in Article 42 of the persons running the special purpose vehicle;

(d) fit and proper requirements for shareholders or members having a qualifying holding in the special purpose vehicle;

(e) sound administrative and accounting procedures, adequate internal control mechanisms and risk-management requirements;

(f) accounting, prudential and statistical information requirements;

(g) solvency requirements.

Those measures, designed to amend non-essential elements of this Directive inter alia by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3)

3. Special purpose vehicles authorised prior to 31 October 2012 shall be subject to the law of the Member State having authorised the special purpose vehicle. However, any new activity commenced by such a special purpose vehicle after that date shall be subject to paragraphs 1 and 2.

2.2. Recital (91) – (94)

(91) Appropriate rules should be provided for special purpose vehicles which assume risks from insurance and reinsurance undertakings without being an insurance or reinsurance undertaking. Recoverable amounts from a special purpose vehicle should be considered as amounts deductible under reinsurance or retrocession contracts.

(92) Special purpose vehicles authorised before 31 October 2012 should be subject to the law of the Member State having authorised the special purpose vehicle. However, in order to avoid regulatory arbitrage, any new activity commenced by such a special purpose

vehicle after 31 October 2012 should be subject to the provisions of this Directive.

(93) Given the increasing cross-border nature of insurance business, divergences between Member States' regimes on special purpose vehicles, which are subject to the provisions of this Directive, should be reduced to the greatest extent possible, taking account of their supervisory structures.

(94) Further work on special purpose vehicles should be conducted taking into account the work undertaken in other financial sectors..

3. Advice

3.1. Background

3.1. Article 13(26) of the Level 1 text defines an SPV as

"*any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such an undertaking*"

3.2. Traditionally CEIOPS has seen that the structure of an SPV transaction could take a number of different forms depending on the nature of the risks transferred and structure of the arrangement itself. Some life SPVs to date have assumed risks such as lapse risk[10] or excess mortality[11] and transferred those risks to the capital markets. Some non-Life SPVs to date have assumed risks like motor risks, and natural catastrophe risks such as windstorm risks and earthquake risks and transferred those risks to the capital markets.

3.3. The Directive will oblige Member States to allow SPVs to be established in their jurisdiction subject to harmonised authorisation requirements as set out by Article 211. In order for the undertaking concerned to benefit from the regulatory capital relief[12] available the SPV would therefore need to be authorised by the supervisory authority; otherwise the SPV would fall outside the scope of this advice.

3.4. It is important to note that if the conditions for authorisation have been adequately met by the SPV then the transaction should be considered for risk mitigation recognition within the solvency calculations of the undertaking akin to a reinsurance transaction, including appropriate allowance within recoverables covering the technical provisions (see Recital 91) and the risk profile changes within the SCR. Therefore, it is important that the decision regarding authorisation of the SPV and its recognition within the solvency calculations of the undertaking are consistent.

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[10] Higher lapses than expected will reduce the cashflows generated by the embedded value business.

[11] The payback of the bond depends on the mortality experience. If the mortality experience is lower than was assumed when pricing the bond the payback will be accelerated (and vice versa).

[12] When discussing "regulatory capital relief" CEIOPS is referring to recognition by the undertaking as a reinsurance recoverable for the purposes of calculating technical provisions and adjustments to the SCR for risk mitigation.

3.5. It will remain a matter for Member States whether they allow SPVs not falling under Article 13(26) and Article 211. Such SPVs (for example, SPVs that only transfer non-insurance risks) may be considered by supervisory authorities for regulatory capital relief under risk mitigation purposes.

3.6. Supervisory authorisation for the regulatory requirements and the scope of supervisory review of an SPV and its use should address a number of specific outcomes, among which:

- What is the structure of the SPV arrangement?
- What risks are to be assumed by the SPV and what are the terms and conditions for payment?
- How has the SPV satisfied the fully funded concept?
- What is the investment policy of the SPV?
- What benefit does an undertaking obtain from transferring risk to an SPV?
- How does this benefit differ from the treatment of traditional securitisation[13]?
- How does this benefit reflect retained risk or potential risk by the undertaking, particularly counterparty and reputation risk?
- What additional complexity does the risk transfer present to the supervision of the undertaking and its group?
- How does the balance sheet for solvency purposes of the undertaking differ from its accounting balance sheet after a risk transfer and why?

3.7. Supervisory authorities should assess that the above questions are appropriately answered, an appropriate mechanism is in place to transfer risk and that the appropriate documentation has been received before approving an SPV (and that the documentation is assessed and each of the principles mentioned in this paper are fulfilled).

3.8. The principles below, under the headings of the paragraphs in Article 211, go some way towards answering these issues. Under a principles-based approach, this means they will need to be considered on a case-by-case basis due to the variety of SPV transactions that could be undertaken. As it is not possible to anticipate the specific nature that these risk transfers may take in future years, in considering an SPV application, supervisory

[13] When undertaking such a transaction an undertaking could use a traditional securitisation arrangement as opposed to an SPV. Securitisation often utilises an SPV in order to reduce the risk of bankruptcy and thereby obtains lower interest rates from potential lenders. Supervisors should understand why the particular arrangement used has been selected.

authorities should consider the economic effect of the transaction over its legal form. Establishing high-level principles for a supervisory framework aims not to inhibit the ongoing development and evolution of SPVs, while also allowing an appropriate supervisory review process in relation to these transactions.

3.9. The supervisory approach CEIOPS is aiming for is to set some fundamental requirements that the SPV needs to meet at authorisation and for it to continue to meet those requirements on an on-going basis. In parallel the undertaking who transferred risk to the SPV will be subject to on-going supervision. This approach is aligned with the fact that the undertaking benefits in terms of capital relief from the transfer of risk to the SPV.

3.2. The scope of authorisation

3.2.1 Explanatory text

3.10. The definition of an SPV in Article 13(26) of the Level 1 text sets out the scope of an SPV's authorisation, including its permitted range of activities as constrained by the preconditions of its authorisation.

3.11. In CEIOPS' view, SPVs should only be considered for authorisation in a Member State if a) and either b) or c) of the following three scope issues are fulfilled:

a. the transaction has the structure of an SPV as defined in Article 13(26) and meets the requirements established in the rest of the paper below; and either

b. the SPV assumes risk from an undertaking through a reinsurance contract[14]; or

c. the SPV assumes insurance risks from an undertaking transferred through a contract that is 'reinsurance like'.

3.12. The SPV should be restricted from engaging in activities other than assuming risks from undertakings, except for activities directly arising from that business.

3.2.2 Potential re-use and changes in the SPV's terms

3.13. The SPV authorisation should only be valid for the purpose for which it was established, which may include potential future reuse. CEIOPS' believes that if in the authorisation process the undertaking has clearly stated the aim of reusing the SPV, along

[14] This could therefore include risks other than insurance risks within the contract to which insurance liabilities are exposed.

with the details of the reuse, then detailed follow up discussions should not be necessary when the envisaged reuse occurs if the same circumstances apply as at authorisation of the SPV and the SPV is acting within its articles of incorporation.

3.14. If the proposed reuse was not planned and discussed with the supervisor at initial authorisation[15] or if initial authorisation was granted subject to a proviso that a potential reuse would have to be approved by the supervisor, the anticipated reuse of an SPV needs prior approval[16] from the supervisory authority where the SPV has been established. Re-entering the approval process with the supervisory authority needs to occur for any regulatory capital relief to be taken by the undertaking for the SPV under the new arrangement. Approval should therefore be applied when the circumstances are changing or the objective of the SPV is different or when the SPV's incorporation documents have been amended.

3.15. If during the lifetime of the SPV it assumes any additional risks, has any changes made to the contracts involved or has further capital raised from investors and placed into it after authorisation, which was not as agreed at authorisation[17], then any material changes[18] need to be subject to prior supervisory approval.

3.16. The approval process, for both the reuse of the SPV or for any change of its characteristics (e.g. additional risks assumed or capital placed into it, or contracts involved) during its lifetime should be proportionate to the nature, scale and complexity of the transaction that is taking place and may not require a full authorisation process as would be needed at the original establishment of the SPV. The supervisory authority should consider if these changes constitute a change in the objectives of the SPV, in which case a more exhaustive authorisation process will be required. Supervisors would expect to be kept informed of all material changes to the SPV.

3.17. An SPV may only be reused for another transaction than the one for which it was established if the contract period has expired or all the risks assumed have been settled, transferred or have terminated and all amounts due to the undertaking or investors have been paid (or, in the case of investors, the investors have agreed that such amounts are to be reinvested in the SPV). In this situation the undertaking may use the same legal structure which may reduce administrative costs.

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[15] Such a case should remain exceptional.

[16] The use of the word "approval" is meant to distinguish this process from (initial) authorisation. Approval would need to look at the key conditions set out in this advice, such as continued effective risk transfer, transparency and being fully funded.

[17] Either because the changes were not planned and discussed with the supervisor at authorization or because the authorization was granted subject to a proviso that potential changes would have to be approved by the supervisor.

[18] Undertakings should bear in mind that a number of minor changes may ultimately result in a material change.

3.18. If the reuse of an SPV is not approved, because the SPV does not continue to meet all of the below mandatory conditions, then failure to gain approval would result in the SPV being treated in the same manner as an SPV that is not authorised, notwithstanding other possible supervisory measures.

3.19. In accordance with Article 211(3), SPVs authorised prior to the date referred to in Article 309(1) shall be subject to the law of the Member State having authorised the SPV. SPVs that have been authorised prior to the adoption of the Solvency II Directive shall therefore not be subject to the conditions set out below and will continue to be subject to the law of the Member States in which they were authorised as previously agreed with their supervisory authority prior to the implementation of Solvency II. However, if any new activity is commenced by such an SPV after the date the Directive becomes effective this would require supervisory approval subject to the requirements set out here in accordance with Article 211(3). CEIOPS may develop further details here under its Level 3 work.

3.2.3 Supervisory responsibilities

3.20. Where an SPV is to be located in an EEA jurisdiction other than where the undertaking is located, the decision for authorisation of the SPV should be taken by the supervisory authority in the jurisdiction where the SPV is to be established. Prior to granting authorisation of the SPV, the supervisory authority where the SPV is to be established should consult the supervisory authority of the undertaking[19] as if the requirements set out in Article 26 applied. This consultation should be accompanied by an exchange of relevant documentation provided with the authorisation request.

3.21. If the views of the supervisory authorities cannot be reconciled regarding the decision for authorisation, the matter should be referred to CEIOPS[20]. The supervisory authority where the SPV is to be established shall keep the supervisory authority of the undertaking informed of the result of the authorisation process. Authorisation of the SPV shall mean that the undertaking is granted appropriate capital relief depending to the level of risk transfer associated with the SPV.

3.22. The same process as described in the previous paragraphs also applies regarding the approval of reuse of SPV or changes to the SPV's terms when an approval is necessary.

3.2.4 SPVs used by more than one undertaking

[19] If there is more than one undertaking within the same group in different Member States then all the supervisors in these Member States should be involved (Art 248(4)).

[20] When future role of CEIOPS under the de Larosière proposals and European Commission draft regulation this is expected to be clarified.

3.23. CEIOPS believes that SPVs could be used by more than one undertaking within the same group, to transfer risk to outside this group. However an SPV should only be used by one group and not by a number of undertakings from different groups. This is because SPVs can involve complex transactions and in CEIOPS' view should be kept transparent. CEIOPS holds the view that the benefits which include the clarity of only having an SPV used by one group outweigh any additional costs of a number of groups setting up their own individual SPVs.

3.24. Where separate undertakings within a group use an SPV, that SPV should be established in such a way that the SPV is protected from the impact of a related undertaking within a group being wound up ("such as a bankruptcy remote vehicle")[21]. If one undertaking utilises an SPV then, without this condition, the assets of the SPV could be pooled and used to contribute to the debts of a related undertaking instead of the obligations under the contract. The fact the insurer is being wound up will usually have no impact on the obligations of the SPV "under the contract".

3.2.5 Pre-authorisation process

3.25. CEIOPS recognises that establishing SPVs can be a costly and time-consuming process and undertakings would therefore appreciate early engagement with the supervisor. CEIOPS does not propose to mandate such a requirement but considers these matters fall within the scope of ongoing contact between supervisors and undertakings. The supervisory authority may be able to discuss requirements at an initial stage of the establishment of the SPV, but the undertaking should recognise that only when final documentation has been received can the decision process commence.

3.26. On receipt of the final complete documentation, the supervisor should make their decision regarding authorisation of the SPV no later than 6 months after the complete documentation has been received[22]. Any refusal for authorisation should be notified to the undertaking and accompanied by precise grounds for doing so.

CEIOPS' advice

Scope of authorisation

3.27. SPVs shall only be considered for authorisation in a Member State if a) and either b) or c) of the following three scope issues are fulfilled:

a. the transaction has the structure of an SPV as defined in

[21] In a number of Member States if an undertaking is to be wound up then assets of related undertakings in its group may be pooled.

[22] This is in line with Article 25 of the Level 1 text (possibility to appeal if a decision is not granted within 6 months).

Article 13(26) and meets the requirements established for SPVs; and either

b. the SPV assumes risk from an undertaking through a reinsurance contract[23]; or

c. the SPV assumes insurance risks from an undertaking transferred through a contract that is 'reinsurance like'.

3.28. If in the authorisation process the undertaking has clearly stated the aim of reusing the SPV, along with the details of the reuse, then detailed follow up discussions shall not be necessary when the envisaged reuse occurs if the same circumstances apply as at authorisation of the SPV and the SPV is acting within its articles of incorporation. If the proposed reuse was not planned and discussed with the supervisor at initial authorisation or if initial authorisation was granted subject to a proviso that a potential reuse would have to be approved by the supervisor, the anticipated reuse of an SPV needs prior approval from the supervisory authority where the SPV has been established.

3.29. Where an SPV is to be located in an EEA jurisdiction other than where the undertaking is located, the decision for authorisation of the SPV shall be taken by the supervisory authority in the jurisdiction where the SPV is to be established. Prior to granting authorisation of the SPV, the supervisory authority where the SPV is to be established should consult the supervisory authority of the undertaking. This consultation should be accompanied by an exchange of relevant documentation provided with the authorisation request. If the views of the supervisory authorities cannot be reconciled regarding the decision for authorisation, the matter should be referred to CEIOPS.

3.30. Where separate undertakings within a group use an SPV, that SPV shall be established in such a way that the SPV is protected from the impact of a related undertaking within a group being wound up.

3.3. Mandatory conditions to be included in all contracts issued

<u>**Explanatory text**</u>

3.31. Authorisation of the SPV should be contingent on certain mandatory conditions being present within the contractual arrangements between the undertaking, investors and the SPV.

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[23] This could therefore include risks other than insurance risks within the contract to which insurance liabilities are exposed.

3.32. After authorisation the SPV should be monitored by the supervisory authority that authorised the SPV as part of the regular Supervisory Review Process (SRP). The SPV shall, in a timely manner, notify the supervisory authority of any subsequent material[24] developments which give rise to possible breaches of the conditions underlying the decision on authorisation (i.e. of any circumstances that may give supervisors reason to reassess the compliance with the approval requirements).

3.33. If any mandatory conditions are breached the undertaking and/or persons responsible for running the SPV need to inform the relevant supervisory authorities[25] immediately on discovery of a breach and discussions between the undertaking, those persons running the SPV and the supervisory authority should follow.

3.34. The supervisory authority of the undertaking should be consulted regarding any supervisory actions, prior to those actions being taken, except where the conditions of Article 250(2) apply. Such actions should, in the first instance, include discussion between the SPV and its supervisor to determine which requirements have been breached and how this situation arose. The undertaking should expect that supervisory actions are subject to a due process (which may be developed by CEIOPS at Level 3) and are undertaken as part of on-going supervision. As a last resort, supervisory actions could include withdrawing the authorisation of the SPV.

3.35. The supervisory authority where the SPV is established should take into account concerns raised by the supervisory authority of the undertaking concerning a possible breach of mandatory conditions by the SPV. If the views of the supervisory authorities cannot be reconciled, the supervisory authority of the SPV as well as the supervisory authority of the undertaking concerned may consult CEIOPS who should resolve the dispute.

3.36. The mandatory conditions below are those that need to be satisfied in order for the supervisory authority to be able to authorise the SPV in accordance with Article 13(26) and Article 211, which would then result in a reduction in the undertaking's capital requirements and the ability to recognise the recoverables as covering part of the technical provisions as appropriate. If these conditions are not satisfied then the supervisory authority should not authorise the SPV[26].

[24] In order to clarify the meaning of materiality in this context, CEIOPS refers to its definition of materiality developed for the reporting purposes in CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: System of Governance, CEIOPS-DOC-29/09, see http://www.ceiops.eu/index.php?option=content&task=view&id=581).

[25] This would include both the supervisory authority where the SPV is established along with the supervisory authority of the undertaking if the two are different.

[26] This would mean no reduction in the undertaking's capital requirements and no recognition of recoverables to hold against technical provisions.

3.37. Below are a number of principles that should be included in the mandatory conditions of the contracts issued in relation to the establishment of the SPV for authorisation:

3.3.1. Principle 1 – Fully Funded

3.38. The definition of an SPV in Article 13(26) of the Directive requires the SPV to be fully funded. This fully funded principle requires the SPV at all times to have assets that are equal to or greater than the aggregate limit of its obligations at any time including any fees and expenses[27]. The contract transferring risk between the undertaking and the SPV must have a clear aggregate limit. Contracts without aggregate limits (potential unlimited liability) could not satisfy the condition to be fully funded. The SPV must be fully funded up to the clearly defined aggregate limit in the contract (together with fees and expenses as noted above).

3.39. To assess the fully funded concept, assets and liabilities should be measured on a Solvency II valuation basis, and the level of assets should be continuously monitored to ensure compliance with the fully funded concept[28].

3.40. Contractually due future premium or investment income may be considered to satisfy the fully funded criteria for future fees and expenses only (not its obligations to the undertaking except as set out in the next paragraph). If the SPV is relying on investment income to fund future fees and expenses then at authorisation the undertaking should run a number of stress and scenario tests which should demonstrate that these future fees and expenses can be met out of future investment income. The design and results of these stress tests on investment income should be discussed with the supervisory authority during the authorisation process.

3.41. In a Life SPV situation, claims reserves may run down from a starting peak. However, for long-terms blocks which are closed to new business, it is possible that renewals mean that the reserves have not yet peaked. In those situations it is envisaged that the increase in reserves could be fully funded by contractually due future receipts[29]. An SPV has to ensure compliance with the fully funded principle.

3.42. It is this fully funded condition that differentiates an SPV from a traditional (re)insurance undertaking. Only when the proceeds of debt issuance or other financing are received by the SPV would the

[27] Anticipated fees and expenses should include, for example, staff, accommodation, claims handling costs and professional advisers' fees.

[28] A guaranteed level of assets can be maintained through derivative instruments such as a total return swap. The use of any derivative instruments should adhere to the "prudent person" principle, but even in this case the SPV should monitor any credit risk in relation to the counterparties.

[29] If the contractually due future premiums are not received no claims reserves will arise for the unpaid premium.

SPV be considered fully funded. Financing the SPV on a contingent basis through for example a standby facility or letter of credit should not be allowed. At no period in time would its assets be insufficient to meet its liabilities as they fall due. If the value of the assets falls below the value of the potential reinsurance recoveries or aggregate liabilities this should be reported immediately to the undertaking and the supervisory authority where the SPV is established and the supervisory authority of the undertaking, if they are not the same.

3.3.2. Principle 2 – Investors have a subordinated claim on SPV assets

3.43. The assets of the SPV must be available to first meet its obligations to the undertaking. The definition of the SPV requires that the rights of the finance providers be fully subordinated to the obligations of the SPV. The undertaking is therefore free to draw down on the assets of the SPV in order to meet the pre-defined liabilities[30]. Unless agreed at authorisation, only at the expiration of the SPV's cover and when there are no further liabilities under the contracts, can any surplus outstanding after the SPV's obligations have been satisfied be returned to capital providers. Any allowance for repayments prior to this should be explained to the supervisory authority and agreed at authorisation, along with an estimation of the expected repayments to be made over the lifetime of the SPV.

3.44. The contractual conditions and location of the assets should guarantee that there are not any constraints that impede timely access to the assets in order to settle the obligations of the SPV.

3.3.3. Principle 3 – "Prudent person"

3.45. The SPV should adhere to the "prudent person" investment principles[31]. In CEIOPS' view the following is the appropriate application of this principle to the investment strategy of SPVs:

a) Assets should reflect the duration of underlying liabilities.

3.46. The SPV is expected to pay due regard to the time horizon of its underlying liabilities when deciding upon its investment strategy, meaning that assets and liabilities are cashflow matched and the liquidity risk of the assets is managed appropriately.

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[30] 'Pre-defined' refers to all reinsurance liabilities of the SPV between the undertaking and the SPV.

[31] The prudent person principle is to be developed further by CEIOPS, and other areas of the prudent person principle may also apply to SPVs as this work progresses.

b) Assets should be of a high quality and counterparty exposures should be sufficiently diversified.

3.47. The SPV would be expected to invest in high quality assets[32]. These assets should be adequately diversified. Counterparty exposures should also be adequately diversified to ensure that the SPV is not exposed to undue default or concentration risk. It is expected that this should be discussed and agreed by the supervisory authority where the SPV is to be located before authorisation. Exposures to derivative contracts should also be included in this assessment.

3.48. The SPV may need to invest in certain assets to fulfil its purpose or to minimise the risk to a ceding undertaking, for example, the SPV may need to invest in certain investment assets to cover linked insurance liabilities, or assets may be withheld by the ceding undertaking. In these circumstances, the SPV has to demonstrate how the "prudent person" principle is satisfied in relation to the quality of assets and diversification of counterparties.

3.49. Given the application of the "prudent person" investment requirements above, there should be minimal investment risk in the SPV.

c) Derivatives should be used only for risk reduction and efficient portfolio management.

3.50. Derivatives may be used by SPVs (e.g. interest rate swaps where the fixed income coupons are swapped into variable rate coupons with the counterparty through a total return swap). However, the use of derivatives is only permitted for risk reduction and efficient portfolio management. Derivatives should not be permitted in those instances in which the sole use of the instrument is to allow further leverage.

3.51. Derivatives associated directly with assets and liabilities should not be permitted unless they mitigate the risk of an asset or liability owned by the SPV[33] and for total return swaps, the change in the value of the derivative matches exactly the change in the value of the underlying asset. Details on the derivative strategy should be established at authorisation which should therefore be assessed during the authorisation process of the SPV.

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[32] The risk is not the quality of assets per se but the fact that the SPV needs to maintain the fully funded requirement and has assets of sufficient liquidity to pay its obligations as they arise. The risks here if asset values were to fall are the ability to inject new funds into the SPV to ensure it remains fully funded or if the use of derivatives or swaps for example continues to operate effectively to maintain the value of the assets.

[33] CEIOPS expects that the ownership of any assets is maintained by the SPV in a derivative transaction.

3.3.4. Principle 4 – Effective risk transfer

3.52. The SPV transaction should effectively transfer risk from the undertaking to the SPV and thereby to the investors. The amount of risk transfer will determine the amount of credit that the undertaking can take for the SPV in terms of any reduction in the undertaking's capital requirements or the ability to recognise the recoverables as covering part of the technical provisions. This should be linked to the aggregate limit of the contract. If no risk transfer occurs then the SPV will not satisfy this mandatory condition[34].

3.53. The onus is on the undertaking to ensure that effective risk transfer has taken place and to demonstrate this to the supervisory authority where the SPV is established who should assess that effective risk transfer has taken place and that this has been fully documented by the undertaking. The contractual arrangements and supporting documentation should, for example, clearly define the risks transferred, the nature, scale and scope of the SPV's obligation to the undertaking, the life of the SPV over which the SPV remains fully funded, the principal repayment schedule and rights to residual returns. This should be approved by the administrative or management body of the undertaking.

3.54. Generally supervisory authorities should assess whether there is effective risk transfer, having regard to the economic effect of the transaction. The risks transferred into the SPV need to be clearly defined so that they may not be used to back any similar transactions, i.e. the undertaking can not double count any regulatory capital relief provided for similar risks.

3.55. CEIOPS considers, as an example, that most indemnity-based arrangements effectively transfer risk where there is no material basis risk, however, parametric or index/model triggered coverages that may use 'reinsurance like' contracts that could result in a material level of basis risk should be assessed on a case-by-case basis. For undertakings using the standard formula to calculate their SCR, the undertaking needs to prove that the risks that remain after the transaction are adequately captured by the standard formula. If this is not the case, as for example there is a material level of basis risk not adequately captured by the standard formula (i.e. through a non-indemnity trigger) then an SPV is only likely to be authorised for undertakings that have adequately modelled these risks using a full or partial internal model. This approach is in line with CEIOPS' Level 2 Advice on SCR Standard Formula – Reinsurance Mitigation)[35].

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[34] Hence no reduction in the undertaking's capital requirements or technical provisions should be afforded. The undertaking needs to prove the extent to which there is an effective transfer of risk into the SPV in order to ensure that any regulatory capital reduction resulting from its arrangements with the SPV is proportionate to the level of risk transfer.

[35]

3.56. An SPV arrangement is unlikely to be authorised[36] if it has a significant amount of basis risk associated with it. This is consistent with the principles laid out in the Level 2 advice on "Allowance of Reinsurance Mitigation Techniques (Articles 111 e) and f))" that covers SPVs. CEIOPS may develop more in this area in its work at Level 3.

3.3.5. Principle 5 – Non-recourse

3.57. Payments due to investors under the terms of the SPV contract are the obligation of the SPV only and in the event of default investors will not have recourse to the assets of the undertaking.

CEIOPS' advice

Mandatory conditions to be included in all contracts issued

3.58. The contracts shall include the following conditions:

a. That the SPV shall be fully funded on a Solvency II valuation basis at all times which requires the SPV to have assets that are equal to or greater than the aggregate limit of the SPV's obligations at any time (including any future fees and expenses). Only when the proceeds of debt issuance or other financing are received by the SPV, could those assets be used to meet the fully funded criteria. Contractually due future premium or investment income may be considered to satisfy the fully funded criteria for future fees and expenses only (not its obligations to the undertaking except for some Life SPV where claims reserves may run down from a starting peak.

b. That the assets of the SPV must first be available to meet its obligations to the undertaking, as investors have a subordinated claim on the SPV's assets (unless prior repayments to investors have been explained to the supervisory authority and agreed at authorisation).

c. That the SPV shall adhere to the "prudent person" investment principles of the Directive, and also include the following three points:

- Assets shall reflect the duration of underlying liabilities;
- Assets shall be of a high quality and counterparty exposures should be sufficiently diversified; and
- Derivatives shall be used only for risk reduction / efficient portfolio management.

[36] It should be noted that the contract would also need an aggregate limit in order to satisfy the authorisation requirements.

d. That the SPV transaction shall effectively transfer risk from the undertaking to the investors and that the risks assumed into the SPV need to be clearly defined so that they may not be used to back any similar transactions.

e. That payments due to investors under the terms of the contract with the SPV are the obligation of the SPV only and, in the event of default, investors will not have recourse to the assets of the undertaking.

3.59. After authorisation, the SPV shall, in a timely manner, notify its supervisory authority of any subsequent material development that may give rise to possible breaches of the conditions underlying the decision on authorisation. If any mandatory conditions are breached the undertaking and/or persons responsible for running the SPV need to inform the relevant supervisory authorities immediately on discovery of a breach and discussions between the undertaking, those persons running the SPV and the supervisory authority should follow.

3.60. The supervisory authority of the undertaking shall be consulted regarding any supervisory actions, prior to those actions being taken, except where the conditions of Article 250(2) apply. Such actions shall, in the first instance, include discussion between the SPV and its supervisor to determine which requirements have been breached and how this situation arose. The undertaking shall expect that supervisory actions are subject to a due process and are undertaken as part of on-going supervision. As a last resort, supervisory actions could include withdrawing the authorisation of the SPV.

3.3.6. Documentation requirements

3.61. The authorisation of the SPV by the supervisory authority where the SPV is planned to be established should be based on appropriate documentation being submitted to this supervisory authority. This documentation is important for authorisation (or approval if the SPV is being re-used or there are changes to its terms) as it should allow the supervisory authority to understand the details of the proposed SPV transaction and to determine whether the conditions of authorisation have been adequately met.

3.62. An external legal opinion, commissioned by the undertaking, may accompany the documentation where it is deemed that a legal opinion is relevant to ensure that it complies with the requirements for approval. CEIOPS may develop this further at Level 3. Documentation requirements that may be needed are set out in the following section.

3.63. The following documents should be submitted, if applicable, in writing, in relation to any possible SPV authorisation. CEIOPS views some documentation as mandatory for all SPV authorisations, but other documentation may only be necessary if proportionate to the nature, scale and complexity of the SPV transaction. Some of the documentation below may be requested as appropriate for approval related to re-use or changes in the SPV's terms.

3.64. The mandatory documentation includes:

a) A copy of the proposed contract between the SPV and the undertaking and a statement containing a description of that contract, accompanied by or including satisfactory information about the identities and qualifications of:

   - the ceding undertaking under the relevant SPV contract;
   - the persons (if any) who are or will be appointed to act as trustees of the SPV's assets;
   - the persons who are or will be officers of the SPV;
   - those persons who have qualifying holdings (whether direct or indirect) in the SPV and the amounts of those holdings; and
   - the persons who are providing or will provide management and other professional services (such as accounting) to the SPV.

b) A copy of the SPV's memorandum and articles, or proposed memorandum and articles of association;

c) A description of:

   - any terms and conditions for payments under the contract between the SPV and the (re)insurance undertaking;
   - the aggregate limit of the relevant contract between the SPV and the (re)insurance undertaking;
   - compliance with the fully funded principle; and
   - stress tests results (where applicable).

d) Actuarial review of underlying business (independent from the undertaking);

e) Prospectus/Offering Circular or Private Placement Memorandum (if any);

f) Overall risk management plan including details as to how the SPV will continue to be fully funded during the term of the contract;

g) Risk implications of the SPV's investment strategy;

h) Details of any intended hedging instruments, such as interest rate swaps or currency contracts;

i) Capital including size, growth, potential investor concentration, and management share of the capital base;

j) A contingency plan explaining what will occur if:

- the fully funded principle is breached (e.g. plans to refund the SPV);
- a disagreement arises over whether a payment is due to the undertaking;
- a counterparty to a material transaction is unable to fulfil the terms of the transaction; and
- any other matters that would materially affect the operation of the SPV occur.

k) Details of Directors/Management fitness and probity;

l) Details on how the SPV meets its system of governance requirements (especially risk management and internal control) as set out in this paper

m) Investment authority and guidelines for assets held in Trust, along with details of any leverage permitted within these guidelines;

3.65. Other documentation that may be required if appropriate:

a) Rating agency's pre-sale report on behalf of the SPV;

b) Details relating to the potential use of financial guarantors on any of the 'tranches' of notes to be issued;

c) Trustee Agreement;

d) Financial projections over the expected life of the SPV;

e) Details of the SPV's liquidity strategy, including structure of waterfall[37], types of positions, and noteholder withdrawal rules;

f) Outsourcing and service contracts;

[37] The term "waterfall" in this context, is used to describe the ranking, or priority of payments.

g) If the SPV is used by several undertakings within the same group, any specific legal arrangement between such undertakings related to the SPV;

h) Any other document deemed necessary by a supervisory authority.

CEIOPS' advice

3.66. The authorisation of the SPV by the supervisory authority where the SPV is established should be based on appropriate documentation being submitted to this supervisory authority. This documentation should allow the supervisory authority to understand the details of the proposed SPV transaction and to determine whether the conditions of authorisation have been adequately met.

3.67. The mandatory documentation includes:

a) A copy of the proposed contract between the SPV and the undertaking and a statement containing a description of that contract, accompanied by or including satisfactory information about the identities and qualifications of:

- the ceding undertaking under the relevant SPV contract;
- the persons (if any) who are or will be appointed to act as trustees of the SPV's assets;
- the persons who are or will be officers of the SPV;
- those persons who have qualifying holdings (whether direct or indirect) in the SPV and the amounts of those holdings; and
- the persons who are providing or will provide management and other professional services (such as accounting) to the SPV.

b) A copy of the SPV's memorandum and articles, or proposed memorandum and articles of association;

c) A description of:

- any terms and conditions for payments under the contract between the SPV and the (re)insurance undertaking; and
- the aggregate limit of the relevant contract between the SPV and the (re)insurance undertaking;
- compliance with the fully funded principle; and
- stress tests results (where applicable).

d) Actuarial review of underlying business (independent from the undertaking);

e) Prospectus/Offering Circular or Private Placement Memorandum (if any);

f) Overall risk management plan including details as to how the SPV will continue to be fully funded during the term of the contract;

g) Risk implications of the SPV's investment strategy;

h) Details of any intended hedging instruments, such as interest rate swaps or currency contracts;

i) Capital including size, growth, investor concentration, and management share of the capital base;

j) A contingency plan explaining what will occur if:

   - the fully funded principle is breached;
   - a disagreement arises over whether a payment is due to the undertaking;
   - a counterparty to a material transaction is unable to fulfil the terms of the transaction; and
   - any other matters that would materially affect the operation of the SPV occur;

k) Details of Directors/Management fitness and probity;

l) Details on how the SPV meets its system of governance requirements; and

m) Investment authority and guidelines for assets held in Trust, along with details of any leverage permitted within these guidelines

3.4. Governance requirements

3.68. The Directive separates governance requirements for SPVs into three separate categories:

a) 'Fit and proper requirements as referred to in Article 42 of the persons running the SPV'

Explanatory text

3.69. The differences between an SPV and conventional reinsurance undertakings do not appear to justify holding those personnel responsible for discharging key functions within the SPV to a different standard, with regard to fit and proper requirements, than those of a reinsurance undertaking. Those persons running the SPV should therefore have an adequate level of knowledge to be able to understand the risks transferred to the SPV and the nature of the SPV transaction that has taken place.

3.70. SPVs shall have in place documented policies and procedures to ensure that all persons subject to fit and proper requirements comply with those requirements. SPVs shall notify the supervisory authority where the SPV is established, of the persons who effectively run the SPV.

CEIOPS' advice

3.71. The persons running the SPV shall be held to the same fit and proper standard as those running a reinsurance undertaking, as established in Article 42.

3.72. SPVs shall have in place documented policies and procedures to ensure that all persons subject to fit and proper requirements comply with those requirements.

3.73. SPVs shall notify the supervisory authority where the SPV is established of the persons who effectively run the SPV.

b) 'Fit and proper requirements for shareholders or members having a qualifying holding in the SPV'

Explanatory text

3.74. "Qualifying holding" is defined as meaning a holding of 10% or more of the capital or voting rights in an undertaking, or having the ability to exercise a significant influence over the management of the undertaking. Similar conditions should apply to SPVs as those that apply to shareholders in a reinsurance undertaking as set out in the Directive. For example, Article 59 of the Directive refers to the sound and prudent management of the (re)insurance undertaking in which an acquisition is proposed, and having regard to the likely influence of the proposed acquirer on the (re)insurance undertaking, the suitability of the proposed acquirer and the financial soundness of the proposed acquisition all of which should be appraised against a number of criteria. These criteria include an assessment of the reputation and experience of any person who will direct the business of the (re)insurance undertaking as a result of the proposed acquisition and of the risk of money laundering or terrorism financing.

3.75. CEIOPS believes that the fitness and propriety of the shareholders or members having a qualifying holding in the SPV should be assessed against the following criteria:

(a) their reputation and integrity;

(b) their financial soundness, in particular in relation to the type of business pursued and envisaged in the SPV.

CEIOPS' advice

Fit and proper requirements for shareholders or members having a qualifying holding in the SPV

3.76. Similar conditions should apply to SPVs as those that apply to shareholders in a reinsurance undertaking as set out in Article 59. The fitness and propriety of the shareholders or members having a qualifying holding in the SPV shall be assessed against the following criteria:

(a) their reputation and integrity;

(b) their financial soundness, in particular in relation to the type of business pursued and envisaged in the SPV.

c) 'Sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements'

Explanatory text

3.77. The SPV should have sound administrative and accounting procedures and adequate internal controls and risk management that are proportionate to the nature, scale and complexity of the SPV transaction. If the scale, nature and complexity of the SPV requires then the other areas and functions of the systems of governance as set out in the Directive could directly apply to the SPV.

3.78. Alternatively, the SPV could, if permitted by the supervisory authority, instead of having these functions itself, make use of relevant functions and expertise within the ceding undertaking, as appropriate, to ensure it has a sound system of governance overall. The system of governance requirements on each SPV should prior to authorisation be agreed between the supervisory authority where the SPV is established and the SPV. Any arrangements between the SPV and the ceding undertaking must be formally agreed in an outsourcing contract.

3.79. CEIOPS may develop, under its Level 3 work on the Supervisory Review Process, harmonised criteria to be used when deciding on the need for the SPV to develop its own governance functions regarding the nature of its business.

3.80. Records should be maintained and accounting procedures established so as to accurately record the activities and transactions of the SPV. Financial statements of the SPV should be recorded under both the same general purposes financial statements (under the national laws where the SPV is established) along with a Solvency II valuation which may differ.

3.81. Any application for an SPV must adequately disclose any material, or potentially material, conflicts of interest that may arise in respect of the interactions among the various parties to the transactions into which the SPV will enter (including any such conflict concerning the applicant/cession undertaking). Any such conflict of interest must be disclosed to stakeholders, including the investors.

CEIOPS' advice

Sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements

3.82. The SPV shall have sound administrative and accounting procedures and adequate internal controls and risk management that are proportionate to the nature, scale and complexity of the SPV transaction. If the scale, nature and complexity of the SPV requires then the other areas and functions of the systems of governance as set out in the Directive could directly apply to the SPV.

3.83. Records shall be maintained and accounting procedures established so as to accurately record the activities and transactions of the SPV. Financial statements of the SPV shall be recorded under both the same general purposes financial statements (under the national laws where the SPV is established) along with a Solvency II valuation which may differ.

3.84. An SPV shall adequately disclose any material, or potentially material, conflicts of interest that may arise in respect of the interactions among the various parties to the transactions into which the SPV will enter. Any such conflict of interest shall be disclosed to stakeholders, including the investors.

3.5. Supervisory reporting (accounting, prudential and statistical information requirements)

Explanatory text

3.85. Primarily, a situation should be avoided in which the on-going supervisory reporting requirements of SPVs are unduly burdensome. Supervisory reporting should be proportionate to the nature, scale and complexity of the risks while at the same time providing supervisors with the information they need to continue to monitor the SPV. The SPV should not, for example, be required to submit its own regular supervisory reporting such as the Solvency and Financial Condition Report (SFCR). It should however be required to file annual accounts in accordance with the national law of the jurisdiction where the SPV has been established[38] and, if different, on a Solvency II valuation basis. The annual accounts should be sent to the supervisory authority where the SPV is established as they are responsible for the SPV's on-going compliance, and also to the supervisory authority of the undertaking. These annual accounts provide access to regular information (on a Solvency II basis) for the supervisory authority where the SPV is established.

3.86. The (re)insurance undertaking which utilises the SPV is required to report all material risks through its supervisory reporting (which includes details on its risk profile and its Own Risk and Solvency Assessment (ORSA)). This includes those risks arising out of any off-balance sheet financing activities[39]. The supervisory reporting completed by the undertaking should provide details on the SPV including a reconciliation of the accounting valuation basis to the Solvency II valuation basis for the SPV along with details of how the fully funded concept is being met.

3.87. These annual accounts of the SPV, together with the undertaking's supervisory reporting (which should include details of the SPV's investments, the effect of the SPV on the undertaking's risk profile and ORSA), would be considered the minimum information required for regulatory purposes for the supervisory authority where the SPV is established (to monitor on-going compliance of the SPV after authorisation) and for the supervisory authority of the undertaking (to monitor the undertaking). The SPV should also be taken into account in the on-going supervision of the undertaking, for instance through supervisory assessment of the undertaking's risk profile or ORSA.

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[38] If a Member States national law currently does not stipulate that SPVs should compile annual accounts, the Member State should ensure that these are required when the Solvency 2 Directive comes into force, including for SPVs which are not incorporated.

[39] Including those that are beyond the scope of this advice e.g. non-insurance SPVs or SPVs set up outside the European Economic Area, provided the Member State where the undertaking is located allowed the use of SPVs not falling under Article 13 (26) and Article 211 as mentioned in this Level 2 Advice.

3.88. If the supervisory authority where the SPV is established has any concerns with the SPV the supervisory authority where the SPV is established should inform the supervisory authority of the undertaking immediately except where the conditions of Article 250(2) apply.

3.89. The SPV may however be required to submit further ad hoc statistical and financial information above the minimum required as determined by the supervisory authority of the SPV. Such information could be required following a pre-defined event such as a breach of any mandatory conditions or if the SPV has further risks transferred to it, which would require approval or in case of deteriorating market conditions. These requirements should be assessed on a case-by-case basis.

3.90. Any separate ad hoc regulatory reporting requirements, for example further ad hoc statistical and financial information, on the SPV in excess of the annual accounts will be determined on a case by case basis.

CEIOPS' advice

Accounting, prudential and statistical information requirements

3.91. The SPV should be subject to the same prudential valuation rules as used for (re)insurance undertakings under Solvency II.

3.92. On an on-going basis, an SPV should be required to file annual accounts in accordance with the national law of the jurisdiction where the SPV has been established and, if different, on a Solvency II valuation basis. The annual accounts should be sent to the supervisory authority where the SPV is established, and also to the supervisory authority of the undertaking. These annual accounts of the SPV, together with the undertaking's supervisory reporting (which includes details on its risk profile and its ORSA), would be considered the minimum information required for regulatory purposes for the supervisory authority where the SPV is established (to monitor on-going compliance of the SPV after authorisation) and for the supervisory authority of the undertaking (to monitor the undertaking).

3.93. The SPV may however be required to submit further ad hoc statistical and financial information above the minimum required as determined by the supervisory authority of the SPV.

3.94. If the supervisory authority where the SPV is established has any concerns with the SPV they should inform the supervisory authority of the undertaking immediately except where the conditions of Article 250(2) apply.

3.6. Solvency requirements

Explanatory text

3.95. Given the Directive requires the SPV to be fully funded it appears that it would not be appropriate for the SPV to be subject to the MCR or SCR capital requirements. However, its credit within the undertaking should be equal or less than the value of the assets recoverable from the SPV. As referred to by Recital 91, the recoverable amounts from an SPV should be considered by the undertaking as amounts recoverable under reinsurance or retrocession contracts.

CEIOPS' advice

Solvency requirements

3.96. An SPV should be fully funded at all times and is not therefore required to calculate an individual MCR or an SCR.

3.7 Intra-group SPVs

3.97. CEIOPS has been considering the possibility of having SPVs that do not raise capital externally and instead the transaction is entirely internal to the group as set out in Article 212 1(c) (intra-group) which is therefore used for the undertaking's own internal risk management purposes.

3.98. An important mandatory condition for authorising an intra-group SPV is that the undertaking cannot use an internal SPV (i.e. one where no element of finance is raised externally) to achieve a regulatory capital reduction at group level in the absence of any financing external to the group.

3.99. Regulatory capital requirements of a group are only permitted to be reduced through SPV arrangements therefore if, and to the extent to which, funding is provided externally, to back the obligations provided by an SPV to undertakings within the group. In the absence of external financing, only the solo undertaking who has the contract with the SPV may take regulatory capital relief for the SPV.

3.100. CEIOPS expects the relevant supervisory authorities to discuss these intra-group SPVs with the undertaking concerned on a case-by-case basis especially around the rationale for the SPV and how it complies with the requirements for authorisation as set out in this advice at a solo level.

3.101.CEIOPS considers that, as separate undertakings within a group using an SPV should ensure the SPV is structured in such a way that the SPV is protected from the impact of a related undertaking within a group being wound up, the same principle should apply to intra-group SPVs.

3.102.The requirements should be assessed in relation to the solo undertaking. CEIOPS may develop this further at Level 3.

CEIOPS' advice

Intra-group SPVs

3.103.Undertakings shall not use intra-group SPV (i.e. one where no element of finance is raised externally) to achieve a regulatory capital reduction at group level in the absence of any financing external to the group.

4. Annex 1 - Requirements for undertakings who use SPVs

Explanatory text

4.1. This section sets out requirements for undertakings who use SPVs. These requirements are out of the scope of Article 211 but are nonetheless important considerations for supervisory authorities and have therefore been included within this advice. This material has also been included in other CEIOPS' advice as deemed relevant.

4.2. It is the responsibility of the administrative or management body of the undertaking to ensure that all mandatory conditions are present within the contractual arrangements at the time of the SPV's authorisation.

4.3. These principles should be applied *mutatis mutandis* in the case where an SPV is set up by different undertakings from the same group.

Effects of the fully funded concept on the undertaking

4.4. CEIOPS proposes that the fully funded requirement should be regularly analysed by the undertaking through its system of governance. The maximum reinsurance credit taken by an undertaking for an SPV should be capped at an amount equal to the lower value between the aggregate maximum liability transferred and the aggregate value of the assets of the SPV. Any fall in the value of the assets within the SPV should be mirrored by a reassessment of the reinsurance asset within the undertaking.

Risks remaining within the undertaking

4.5. CEIOPS would expect that any remaining risk (credit, market, liquidity, operational risk or 'burn-through' that may occur if the insured cost were to exceed the maximum amount payable by the SPV) from the SPV to be fully taken into account in the undertaking through its risk management system and also taken into account within the calculation of its regulatory capital requirements. After authorisation, if this is not properly considered by the undertaking within its capital requirements, the supervisory authority should consider supervisory actions to address these risks. The undertaking should be particularly aware of any residual risks arising from the SPV if there were losses in excess of those envisaged at the time of authorisation. These losses above the funding provided would revert back to the undertaking.

Alignment of interests between the undertaking and the SPV

4.6. There should be an alignment of interests between the undertaking and the SPV to ensure, for example:

- that claims management processes in the undertaking operate effectively;
- to provide a discipline on the underwriting of risks within the undertaking, i.e. the undertaking can not just transfer risks it may not have fully understood or properly managed to an SPV; and
- the SPV is established and subsequently run in an appropriate manner for all the interested parties.

4.7. This alignment could be achieved in a number of ways, for example, by the undertaking retaining an investment through a convertible loan note or a lower rated security in the SPV or the undertaking retaining some of the risks transferred on its balance sheet. CEIOPS may develop the methods on how it assesses the alignment of interest of the undertaking and the SPV further at Level 3.

4.8. Where any assets or rights of an SPV are held or controlled by the undertaking those assets must be separately identified by the undertaking. This provides the undertaking with a vested interest in the operations of the SPV

4.9. CEIOPS considers that this alignment of interests is important to ensure the proper running and functioning of the SPV, even though it is acknowledged that the obligations from the liabilities remain with the undertaking (as in practice no actual liability transfer takes place).

4.10. In principle, full disclosure must be provided by the undertaking to the supervisory authority and all relevant parties on how the interests are aligned, and any relationship between the parties. Such actions may have the economic effect of reducing the level of cover or increasing the risks covered by the solvency capital requirement, and the supervisory authority should be confident this has been properly taken into account.

Transparency

4.11. Full disclosure within the SFCR and the annual accounts of the undertaking should be made regarding its relationship with the SPV. The undertaking should also disclose any financial interests it has in the SPV (i.e. convertible loans, if it has retained or invested in any notes of the SPV).

4.12. Details should also be disclosed of whether it has invested in notes related to other SPVs and details of risks that have been assumed by them and how the undertaking has satisfied itself any concentration risks are within its risk appetite.

Fit and proper requirements for the persons running undertaking

4.13. Before the undertaking enters into an SPV transaction, the supervisory authority should assess whether the administrative or management body of the undertaking has the appropriate modelling and risk management understanding to fully comprehend the risks being transferred to the SPV and the consequences of such actions.

5. Annex 2 – Background details on SPV transactions

An undertaking can use an SPV to transfer risks through a contract, much in the same fashion as the undertaking would cede (retrocede) risk to a typical reinsurance undertaking. The undertaking passes risks to the SPV and may transfer an amount of supplementary assets or pays an adequate premium necessary to offer investors a rate of return (appropriate to the risk). This rate of return is calculated as a percentage of the amount to be raised from the market. The undertaking would, as suggested by Recital 91 of the Level 1 text, then take credit for the risks ceded to the SPV as reinsurance recoverables calculated in accordance with Article 81.

The SPV funds its maximum obligation (equal to the aggregate maximum liability of the contract with the SPV) through the issuance of notes/bonds to the market. Article 81 prescribes how amounts recoverable from the SPV must be calculated, requiring the undertaking to take account of the timing differences between its insurance obligations to policyholders and the speed with which it can recover amounts owing from the SPV.

To provide a simplified example of an SPV transaction, the undertaking is provided with e.g. €300m of cover for its aggregate maximum liabilities from a windstorm in Europe. The coverage is agreed for 3 years. The undertaking pays e.g. €9m per year for 3 years to the SPV as a premium. The SPV raises €300m from investors in the form of notes (Annex 3 details a (re)insurance undertakings' balance sheet before and after the SPV transaction).

The notes are typically 'tranched' in order for priority payment of interest and repayment of capital. Tranches allow for the creation of one or more classes of securities whose rating is higher than the average rating of the underlying liabilities. This is accomplished through the use of credit support specified within the transaction structure to create notes with different risk-return profiles. The first-loss tranche absorbs initial losses, followed by the mezzanine tranches which absorb some additional losses, again followed by more senior tranches. Thus, due to tranching, the most senior claims are expected to be insulated – except in adverse circumstances – from the risk of the underlying liabilities through the absorption of losses by the more junior claims. Some of the notes may be "wrapped" by a financial guarantor in order to obtain credit enhancement.

Step 1: The SPV invests the proceeds of the notes (€300m) in predefined assets such as government bonds with a fixed interest rate of e.g. 4%.

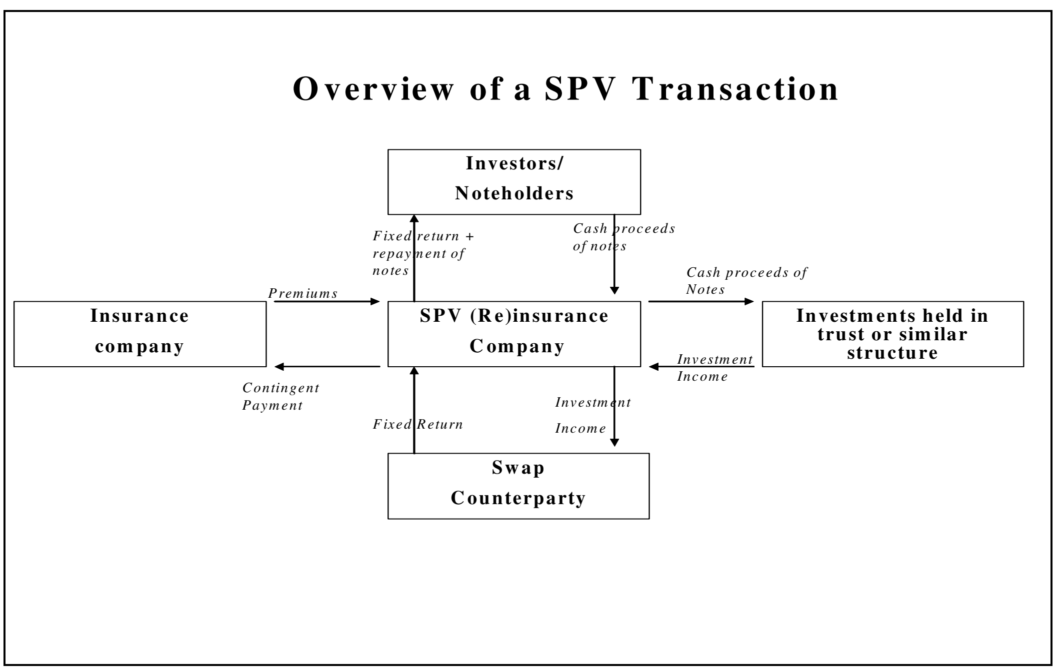
Step 2: The SPV enters into a total return swap arrangement with a counterparty, typically an investment bank, to swap the fixed rate return (4%) for a floating rate return (such as EURIBOR). The purpose is to hedge out interest rate risk to avoid mark-to-market losses in the assets of the SPV from rising interest rates. This provides stability to the value of the assets for the bond holders and the undertaking when ensuring that the SPV complies with the fully funded principle.

Step 3) If there are no claims, the SPV receives the fixed return on government bonds (4%) and swaps this for a floating rate (such as EURIBOR).

Step 4) If there are no claims the SPV pays the investor the floating rate plus the premium (in this instance €9m). This is an attractive return and theoretically has little correlation to the performance of other asset classes held by the investor. It also provides the investor with an opportunity for diversification within its investment portfolio.

Step 5) If there is a claim on the liabilities assumed by the SPV, the undertaking receives the amount of the claim from the SPV. For example, in year 3 if there was a claim for €300m, the undertaking would receive €300m. In this case the investor receives nothing back from the SPV.

Step 6) If there is no claim by the end of year 3 on the liabilities of the SPV, the investor receives back the principal (€300m) as well as the scheduled interest payments.



There are a number of mechanisms used by SPVs as trigger events that would oblige the SPV to make payment to the undertaking. These could include:

- Parametric – a pure parametric trigger is based on an actual reported physical event (e.g. magnitude of an earthquake, wind speed of a hurricane or an increase in longevity);
- Indemnity – an indemnity transaction is based on the actual loss of the undertaking;
- Model Loss – insurance losses are determined by inputting actual physical parameters into an agreed fixed model which then calibrates the loss;
- Industry index – based on an industry wide index of insurance losses; and
- Hybrid (a trigger combining more than one of the above triggers).

Supervisory authorities may consider other aspects of the coverage provided by the SPV (such as an "Ultimate Net Loss" clause) which, when combined with the model loss and parametric triggers, attempt to mirror indemnification.

6. Annex 3 – Balance sheet effect of a SPV

The following illustrates a simple example of an insurance undertaking's balance sheet before and after the SPV transaction as set out in Annex 2 of this advice.

Balance sheet of a non-life insurance undertaking pre-SPV prior to a claim event:

Assets		**Liabilities and Share Capital**	
Investment assets	2,000	Insurance liabilities	2,000
Cash	500	Other liabilities	250
Other assets	500	Shareholders' funds	750
Total Assets	3,000	Total liabilities	3,000

Assume a European windstorm with a claim of €300m

Balance sheet of a non-life insurance undertaking if no SPV is in place:

Assets		**Liabilities and Share Capital**	
Investment assets	2,000	Insurance liabilities	2,300
Cash	500	Other liabilities	250
Other assets	500	Shareholders' funds	450
Total Assets	3,000	Total liabilities	3,000

Balance sheet of a non-life insurance undertaking if an SPV is in place that covers €300m of loss:

Assets		**Liabilities and Share Capital**	
Investment assets	2,000	Insurance liabilities	2,300
Cash	800	Other liabilities	250
Other assets	500	Shareholders' funds	750
Total Assets	3,300	Total liabilities	3,300