EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Own Funds

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on Own Funds measures. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and Insurance Guarantee Schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**). This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of topics as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

Milliman has produced a briefing note giving a summary of EIOPA's proposals in the CP (available here) and separate briefing notes covering each of these topics in more detail. This briefing note covers Own Funds.

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive

Own Funds

EIOPA conducted a comprehensive review of own funds under Solvency II, as the tiering structure differs from the prudential requirements applicable to the banking industry (Directive 2013/36/EU and Regulation (EU) No 575/2013).

In addition, EIOPA was asked to assess whether the items currently included in Solvency II own funds are appropriately attributed to tiers according to the characteristics of permanent availability and subordination.

This briefing note provides a summary of the opinion provided by EIOPA regarding the Solvency II 2020 review on the following topics:

- Tiering and ancillary own funds: This relates to differences in the tiering approaches between the insurance framework and the banking framework, and where these are justified by differences in the business models of the two sectors
- Undue volatility generated by the current tiering limits: This relates to the extent to which the tiering structure of own funds in the Solvency II framework may generate undue volatility of own funds
- Availability of own funds: This relates to whether the availability criteria for own funds are sufficiently clear and appropriate.
- Correct attribution of own funds items to tiers: This relates to the appropriateness of the attribution of own funds items to tiers, according to the characteristics of permanent availability and subordination.

In summary, EIOPA is not proposing any changes to the tiering structure, the tiering limits nor to the attribution of Expected Profits in Future Premiums (**EPIFP**) to Tier 1.

EIOPA is proposing that the group supervisor should assess the level of double leverage and take actions when double leverage is excessive (further details below under "the availability criteria").

Terminology

- Tier 1: **T1**
- Unrestricted Tier 1: **uT1**
- Restricted Tier 1: **rT1**
- Tier 2: **T2**
- Tier 3: **T3**
- National Supervisory Authority: **NSA**

Tiering and Ancillary Own Funds

Proposal: EIOPA is not proposing any change to the Solvency II tiering structure.

NUMBER OF TIERS

In 2018 EIOPA provided its second set of advice to the Commission on specific items in the Solvency II Delegated Regulation (EIOPA-BoS-18/075). A comparison of own funds in the Insurance and Banking sectors was made, as they are not treated similarly for the purposes of eligibility.

That comparison led EIOPA to conclude that the differing terms of the insurance and banking business explain the existence of different requirements for the permanence of capital. Furthermore, the differences in the duration of the failure processes in banks and insurers justify the proportions in the tiering, especially the existence of T3.

Therefore, EIOPA has assessed the possibility of removing T3 own funds, by either moving the tiering structure from 3 to 2 categories (absorb Tier 3 into Tier 2 and combine both Tiers) or removing the T3 category (delete T3 and keep T1 and T2 as defined.

The removal of T3 own funds would impact the following:

1. Ancillary Own Funds (AOF)

Ancillary own funds are classified as either T2 or T3. They are callable on demand, with NSAs responsible for assessing their economic substance. Ancillary own funds are not yet basic own funds until they are called (or paid in) to absorb losses.

That removal of the type T3 own funds would have a limited impact because very few T3 AOFs have been issued and since they are callable on demand, they could become T2 or T1.

2. Net Deferred Tax Assets (Net DTA)

Net deferred tax assets are currently reallocated to T3 (with an upper limit of 15% of the SCR) and are not part of the reconciliation reserve. Removing the T3 would mechanically derive an amount equivalent to the deferred tax asset in the reconciliation reserve (thus reducing the excess of assets over liabilities).

Having the net deferred tax assets in T3 currently represents an inconsistency, since any adjustment for loss absorbing capacity of deferred taxes immediately reduces the SCR.

Furthermore, net deferred tax assets and adjustment for loss absorbing capacity of deferred tax are closely linked and impact each other. The various tax regimes and accounting regimes at European level make deferred tax assets and LAC DT complex topics to discuss.

EIOPA therefore recommends keeping the current legislation without any changes to deferred tax assets, therefore keeping them recognised as an own funds item. A further important point is that any (limited) recognition of the deferred tax effects relying on future probability would increase the volatility of the solvency position.

In the case of a removal of T3 own funds from Solvency II, EIOPA would recommend reclassifying deferred tax assets as T2, possibly with a specific limit expressed as a percentage of the SCR (e.g. 15%) or of total own funds (e.g. one third of total eligible own funds, which is the current limit for T3 own funds according to Article 98 of the Solvency II Directive).

3. Dated subordinated debt instruments

Subordinated loans are classified under T3 own funds. The removal of T3 would disallow the recognition of T3 subordinated debt as an own funds item.

An analysis of EIOPA QRT data for the 3 years 2016 to 2018 provides data in relation to the structure of own funds tiering across all member states. Only 2% of total Own Funds is made up of rT1, 94% is made up of T1 and 5% of T2. T3 represents only 1% of total own funds. T3 has no material value towards the calculation of the SCR ratio on an aggregate basis and is ineligible towards the MCR ratio.

Overall, EIOPA advises not to change the Solvency II Tiering structure.

Undue Volatility

Proposal: EIOPA is not proposing any change to the 20% limit relative to uT1 own funds. EIOPA is not proposing any change to the 50% of SCR limit for T2 and T3.

With regard to SCR compliance, the Delegated Regulation prescribes:

- The eligible amount of T1 items shall be at least one half of the SCR
- The eligible amount of T3 items shall be less than 15% of the SCR
- The sum of the eligible amounts of T2 and T3 items shall not exceed 50% of the SCR

For compliance with the MCR, the following is prescribed:

- The eligible amount of T1 items shall be at least 80 % of the MCR
- The eligible amounts of T2 items shall not exceed 20% of the MCR

rT1 items shall make up less than 20% of total T1 items.

EIOPA considers the 20% limit for rT1 items as this limit could create an undue volatility. When a stressed situation occurs, undertakings will usually see a reduction of their uT1 own funds, while they will also need to manage a potential reduction of eligible rT1 own funds.

There is a pro-cyclical effect derived from the 20% limit of rT1 own funds items (expressed as a percentage of the total T1 own funds items rather than a percentage of the SCR). Therefore, decreases in the amount of uT1 own funds will decrease the eligible amount of rT1 own funds. This unnecessarily affects the solvency position of companies in times of crisis, inducing undesirable volatility in their own funds.

EIOPA has not supported the option to delete the 20% limit, as no satisfactory solution was found to increase the quality of hybrid instruments in order to preserve the total quality of T1 own funds.

A change in the rT1 limit to be expressed as a percentage of the SCR and increasing the minimum limit for T1 own funds items to 60% would eliminate the pro-cyclical effect of the current limit and increase the minimal limit of T1 own funds.

Regarding the limit of the sum of T2 and T3 own fund items as 50% of the SCR, its removal would either imply a potential decrease the quality of own funds to cover the SCR: i.e. eligible own funds will become less absorbing and this will increase the leverage for the insurers with an increased pressure on the free cash flow. This weakens the policyholder protection. Furthermore, the Solvency II Directive requires the proportion of T1 items in the eligible own funds to be higher than one third of the total amount of eligible own funds. This has also the disadvantage of pro-cyclicality (i.e. if T1 decreases due to stress, the eligible T2 plus T3 also decreases).

Removing the 50% limit of T2 plus T3 own funds to SCR induces pro-cyclicality, therefore EIOPA does not support this proposal.

The Availability Criteria

Proposal: EIOPA is proposing that the Group supervisor to assess the level of double leverage and take action when excessive.

“Double leverage” occurs when a parent entity in a group provides T1 capital support to a subsidiary which is financed by externally-issued, parental non-T1 capital. An area which may deserve attention from the supervisor is the case where the parent undertaking shows a ratio of the parent undertaking’s T1 own funds investment in its subsidiaries compared to its own T1 items above 100%. This is referred to as “excessive” double leverage.

In such a situation, the solvency position of the parent company can be at risk and this represents a constraint for the financed undertakings, in particular when a parent undertaking issues senior debt in order to finance an insurance company of the group facing a breach of its SCR. Connected transactions could lead parent undertakings to be unable to fulfil their obligations related to the senior debt, with issues in determining own funds classification if the subordinated debt is not financed by the related insurance company of the group.

Two options are proposed to avoid excessive double leverage:

1. The Group supervisor should assess the level of double leverage and take action when double leverage is excessive (above 100%)
2. Require (as a Pillar II requirement) the regulated entity to assess the financial and solvency situation of the parent company and mitigate the risks arising from double leverage ratio above 100%

EIOPA advises the Commission to amend Article 258 of the Solvency II Directive in order to clarify that the group supervisor should assess the level of double leverage and take actions when double leverage is excessive (e.g. where the leverage ratio is above 100%).

Correct Attribution of Items

Proposal: EIOPA is not proposing any change to the attribution of EPIFP to Tier 1. EIOPA will continue the work on the treatment of EPIFP.

Some NSAs have raised the issue of the incorrect attribution of own funds items to tiers according to the characteristics of permanent availability, mainly regarding the Reconciliation Reserve (RR) and in particular the EPIFP included in this reserve. EPIFP is part of the RR, and thus considered an uT1 item (as per Article 69 and 70 of the Delegated Regulation).

The question is whether EPIFP possess the feature of permanent availability to absorb losses on an on-going basis in order to be classified as uT1, that are own funds of the highest quality. UT1 own fund are expected to be of the highest quality and immediately available to absorb losses, while it is not possible to perform that assessment on the single items included in the RR.

Calculating EPIFP requires a preliminary classification of the portfolio (between contracts with future premiums and contracts without them) and aggregations (on the basis of the existence of the paid-up options) taking correctly into account the contract boundaries initially defined[2].

The value of EPIFP is highly dependent on the valuation method used for the technical provisions and on the assumptions used. EIOPA states that this dependence could increase the risk of under reserving which is balanced with the value of EPIFP and may cause insolvency if:

[2] The level of granularity in the calculation is therefore key.

- the under reserving is not adequately represented by SCR standard formula;
- the risk calculated by standard formula is decreased by the diversification effect, but EPIFP is calculated on a per policy basis without diversification effect;
- the risk could be materialised in a LoB without sufficient EPIFP, in that case the loss will not be counterbalanced.

If contract boundaries are badly applied, high EPIFP reveals an underestimation of technical provisions.

It is also not certain how EPIFP can immediately be available to absorb losses.

Taking into account the nature of EPIFP, EIOPA proposes three options regarding the treatment of EPIFP as an own funds item:

1. No changes in the own funds regulation

The NSA has to monitor and assess the correctness of the EPIFP calculation and take appropriate actions from its Supervisory Review Process (including request for capital add-on).

2. Limiting the recognition of EPIFP as uT1 own funds

Fix a limit (15% to 20%) of the total EPIFP, as reported in QRT, to be recognized as uT1 and the remaining part as T2 or T3 items (depending on the outcome of the advice on tiering approach, i.e. in case of T3 removal) and introduce a transitional period to diminish the immediate impact.

3. Downgrade the tiering of EPIFP

To recognize EPIFP as own funds of T2 or T3, subject to the limits envisaged in Article 82 of the Delegated Regulation (depending on the outcome of the advice on tiering approach, i.e. T3 removal, and the possible removal of tiering limits for T2 + T3) and introduce a transitional period to diminish the immediate impact.

EIOPA prefers option 1, the attribution of EPIFPs to T1 own funds.

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