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

Own funds - Article 97 and 99- Classification and eligibility

(Former CP 46)

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1. Introduction

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 that CEIOPS should develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation.[1]

1.2. This Paper provides advice with regard to the classification of own funds (Article 97) and the eligibility of own funds (Article 99) in the Solvency II Level 1 text.[2]

1.3. Although classification and eligibility are dealt with in separate subsections of the Level 1 text, CEIOPS advice deals with both issues in one paper because they are closely linked.

1.4. The implementing measure foreseen for ring-fenced funds (Article 99) will be consulted upon in a third set of advice to be released for consultation in November 2009, so is not addressed in this paper.

1.5. CEIOPS' advice has been prepared in light of CEIOPS' analysis of the lessons to be learned from the recent crisis which originated and developed in the banking sector and subsequent spread to the insurance sector.[3]

1.6. Transitional arrangements from Solvency I to Solvency II are not addressed in this advice and should be developed as part of the implementing measures. These will need to consider the nature and extent of grandfathering provisions in respect of capital instruments. QIS5 should provide valuable input in this regard.

2. Extract from Level 1 text

2.1 Legal basis for implementing measures

Article 97 implementing measures

1. *The Commission shall adopt implementing measures laying down the following:*

   (a) *a list of own fund items, including those referred to in Article 96, deemed to fulfil the criteria, set out in Article 94, which contains*

[1] See http://www.ceiops.eu/content/view/5/5/
[2] Latest version from 19 October 2009 available at http://register.consilium.europa.eu/pdf/en/09/st03/st03643-re01.en09.pdf
[3] See Lessons to be learned from the crisis- Solvency II and beyond, March 2009, http://www.ceiops.eu/media/files/publications/reports/CEIOPS-SEC-107-08-Lessons-learned-from-the-crisis-SII-and-beyond.pdf

for each own fund item a precise description of the features which determine its classification;

(b) the methods to be used by supervisory authorities when approving the assessment and classification of own fund items which are not covered by the list referred to in point (a).

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

2. The Commission shall regularly review and where appropriate update the list referred to in point (a) of paragraph 1, in the light of market developments.

Article 99 implementing measures

The Commission shall adopt implementing measures laying down:

(a) the quantitative limits referred to in Article 98(1) and (2);

(b) the adjustments that should be made to reflect the lack of transferability of those own fund items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds).

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

2.2 Other relevant Articles from the Level 1 text

Article 88 Basic own funds

Basic own funds shall consist of the following items:

(1) the excess of assets over liabilities, valued in accordance with Article 75 and Section 2;
(2) subordinated liabilities.

The excess amount referred to in point (1) shall be reduced by the amount of own shares held by the insurance or reinsurance undertaking.

Article 89 Ancillary own funds

1. Ancillary own funds shall consist of items other than basic own funds which can be called up to absorb losses.

Ancillary own funds may comprise the following items to the extent that they are not basic own funds items:

(a) unpaid share capital or initial fund that has not been called up;
(b) letters of credit and guarantees;
(c) any other legally binding commitments received by insurance and reinsurance undertakings.

In the case of a mutual or mutual-type association with variable contributions, ancillary own funds may also comprise any future claims which that association may have against its members by way of a call for supplementary contribution, within the following 12 months.

2. *Where an ancillary own fund item has been paid in or called up, it shall be treated as an asset and cease to form part of ancillary own fund items.*

Article 93 Characteristics and features used to classify own funds into tiers

1. *Own fund items shall be classified into three tiers. The classification of those items shall depend upon whether they are basic own fund or ancillary own fund items and the extent to which they possess the following characteristics:*

   (a) the item is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding-up (permanent availability);

   (b) in the case of winding-up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations towards policyholders and beneficiaries of insurance and reinsurance contracts, have been met (subordination).

2. *When assessing the extent to which own fund items possess the characteristics set out in points (a) and (b) in paragraph 1, currently and in the future, due consideration shall be given to the duration of the item, in particular whether the item is dated or not. Where an own fund item is dated, the relative duration of the item as compared to the duration of the insurance and reinsurance obligations of the undertaking shall be considered (sufficient duration).*

   In addition, the following features shall be considered:

   (a) whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem);

   (b) whether the item is free from mandatory fixed charges (absence of mandatory servicing costs);

(c) whether the item is clear of encumbrances (absence of encumbrances).

Article 94 Main criteria for the classification into tiers

1. *Basic own fund items shall be classified in Tier 1 where they substantially possess the characteristics set out in points (a) and (b) of Article 93(1), taking into consideration the features set out in Article 93(2).*

2. *Basic own fund items shall be classified in Tier 2 where they substantially possess the characteristics set out in point (b) of Article 93(1), taking into consideration the features set out in Article 93(2).*

   Ancillary own fund items shall be classified in Tier 2 where they substantially possess the characteristics set out in points (a) and (b) of Article 93(1), taking into consideration the features set out in Article 93(2).

3. *Any basic and ancillary own fund items which do not fall under paragraphs 1 and 2 shall be classified in Tier 3.*

Article 95 Classification of own funds into tiers

Member States shall ensure that insurance and reinsurance undertakings classify their own fund items on the basis of the criteria laid down in Article 94.

For that purpose, insurance and reinsurance undertakings shall refer to the list of own funds referred to in point (a) of Article 97(1), where applicable.

Where an own fund item is not covered by that list, it shall be assessed and classified by insurance and reinsurance undertakings, in accordance with the first paragraph. This classification shall be subject to approval by the supervisory authority.

Article 96 Classification of specific insurance own-fund items

Without prejudice to Article 95 and point (a) of Article 97(1), for the purposes of [the Level 1 text] the following classifications shall be applied:

(1) surplus funds falling under Article 91(2) shall be classified in Tier 1;

(2) letters of credit and guarantees which are held in trust for the benefit of insurance creditors by an independent trustee and provided by credit institutions authorised in accordance with Level 1 text 2006/48/EC, shall be classified in Tier 2;

(3) any future claims which mutual or mutual-type associations of shipowners with variable contributions solely insuring risks listed in classes

6, 12 and 17 in point A of Annex 1[4] *may have against their members by way of a call for supplementary contributions, within the next twelve months, shall be classified in Tier 2.*

In accordance with subparagraph 2 of Article 94(2), any future claims which mutual or mutual-type associations with variable contributions may have against their members by way of a call for supplementary contributions, within the next twelve months, not falling under point 3 of subparagraph 1 shall be classified in Tier 2 where they substantially possess the characteristics set out in points (a) and (b) of Article 93(1), taking into consideration the features set out in Article 93(2).

Article 98 Eligibility and limits applicable to Tier 1, Tier 2 and Tier 3

1. *As far as the compliance with the Solvency Capital Requirement is concerned, the eligible amounts of Tier 2 and Tier 3 items shall be subject to quantitative limits. Those limits shall be such as to ensure that at least the following conditions are met:*

   (a) *the proportion of Tier 1 items in the eligible own funds is higher than one third of the total amount of eligible own funds;*

   (b) *the eligible amount of Tier 3 items is less than one third of the total amount of eligible own funds.*

2. *As far as the compliance with the Minimum Capital Requirement is concerned, the amount of basic own fund items eligible to cover the Minimum Capital Requirement which are classified in Tier 2 shall be subject to quantitative limits. Those limits shall be such as to ensure, as a minimum, that the proportion of Tier 1 items in the eligible basic own funds is higher than one half of the total amount of eligible basic own funds.*

4. *The eligible amount of own funds to cover the Solvency Capital Requirement set out in Article 100 shall be equal to the sum of the amount of Tier 1, the eligible amount of Tier 2 and the eligible amount of Tier 3.*

5. *The eligible amount of basic own funds to cover the Minimum Capital Requirement set out in Article 128 shall be equal to the sum of the amount of Tier 1 and the eligible amount of basic own fund items classified in Tier 2.*

[4] Annex 1, Classes of non-life insurance: Class 6, Ships (sea, lake and river and canal vessels); Class 12, Liability for ships (sea, lake and river and canal vessels); Class 17, Legal expenses.

3. Advice

3.1 Explanatory text

3.1.1 QIS4 feedback

General approach

3.1. The **objective of QIS4 in relation to own funds** was to collect further information, especially on the implementation of the tiering structure. Specifically, elements were classified in relation to how well and when they absorb losses compared to paid-up ordinary share capital or the paid-up equivalent capital of mutual and mutual-type undertakings.

3.2. Overall, **the classification of own funds** was deemed suitable and practicable by undertakings and supervisors. Some undertakings continue to view the three-tier structure as being too complex although in the vast majority of cases the QIS4 specifications, together with the tier structure and limits, **do not result in capital adequacy breaches** and consequently the need to raise additional capital.

3.3. Undertakings generally supported the principle-based approach, although they would welcome greater clarity on some aspects (e.g. the distinction between other reserves that are loss-absorbent for all policyholders and those with restricted loss-absorbency).

3.4. Some supervisors noted some classification difficulties for reserves not specified in the list. Some undertakings and supervisors commented that it was unclear how to classify reserves and provisions such as equalisation reserves/provisions.

3.5. Many undertakings reported that the treatment of deferred taxes is unclear and confusing. Supervisors reported that insurers have not all reported deferred taxes on the same basis, although the impact on own funds cannot be quantified.

3.6. Some supervisors raised concerns about the reliability of the reported classification of hybrid capital instruments and subordinated liabilities. Some reported that a clearer definition of hybrid capital instruments is needed. A number of undertakings and supervisors stressed the importance of grandfathering in relation to hybrid capital instruments and subordinated liabilities.

3.7. The majority of hybrid capital instruments and subordinated liabilities were reported as Tier 2. The main reason for classification in this tier rather than in Tier 1 is that these instruments do not satisfy the loss absorbency requirements, i.e. temporary write-down or conversion. Also, several instruments do not meet the criteria relating to permanence and absence from requirements/incentives to redeem.

3.8. The conclusion drawn by most countries is that the shift from issue date to a reporting date approach when classifying capital instruments into tiers would result in a significant number of instruments changing classification from Tier 1 to Tier 2 or Tier 3, or from Tier 2 to Tier 3. The impact would be particularly significant for Tier 1 instruments.

3.9. Only a few undertakings reported ancillary own funds. There was no useful feedback on the valuation of ancillary own funds.

3.10. Among specific issues tested in QIS4, there were also surplus funds and ring-fenced funds. More about surplus funds can be found under the following subtitle, *Quantitative outcome*. Ring-fenced funds are not addressed in this paper.

Quantitative outcome

3.11. **On average 95% of total own funds were reported in Tier 1, 4% in Tier 2 and 1% in Tier 3.** However, in some countries, own funds reported in Tier 2 and Tier 3 were not negligible.

3.12. Out of 1,366 reporting undertakings in QIS4:

- 35 undertakings reported Tier 1 below one third of SCR,
- 19 undertakings reported Tier 3 above one third of SCR,
- 25 undertakings reported Tier 1 below one half of MCR,
- 53 undertakings reported Tier 2 above one half of MCR.

3.13. Out of the most important capital component, Tier 1, the main proportions were attributable to common equity, retained earnings, and valuation adjustments.

3.14. Subordinated loans represented 53% of Tier 2 and 40% of Tier 3% capital. The greatest part of Tier 3, i.e. 58 %, consisted of supplementary member calls.

3.15. The total volume of hybrid capital instruments and subordinated liabilities in issue across countries was EUR 42,581 million. Amounts reported ranged from zero to EUR 13,076 million. Issuance was concentrated in four countries (DE, FR, IT, UK) which reported circa 85% of the total volume of hybrid capital instruments and subordinated liabilities. The amount of hybrid capital instruments and subordinated liabilities as a proportion of total own funds provided an overview of the relative significance of these items, hence, the potential significance of grandfathering, in those countries. Hybrid capital instruments and subordinated liabilities as a proportion of total own funds ranged from zero (a number of countries did not report hybrid capital instruments or subordinated liabilities) to 17%. On average hybrid capital instruments and subordinated liabilities as a percentage of total own funds was circa 2%.

3.16. The volume of ancillary own funds reported was small in relation to basic own funds (2.5%) and total own funds (2.4%). The percentage of ancillary own funds in relation to basic own funds was lower than 10% in all countries.

3.17. Ancillary own funds reported as Tier 2 were largely supplementary member calls and letters of credits and guarantees. Tier 3 Ancillary Own Funds were mainly made up of supplementary members' calls.

3.18. Seven countries (DE, ES, FI, FR, NL, NO, UK) reported supplementary member calls other than Protection and Indemnity Associations (PIA) for an overall amount of EUR 10.3 billion. For two of these countries (FR (EUR 7 billion) and DE (EUR 3 billion)) this equated to more than 95% of the total amount reported. The total amount of ancillary own funds reported by undertakings of QIS4 (EUR 10.3 billion) was ten times higher than the amount they reported under the current Solvency I regime (EUR 948 million).

3.19. Overall, 48% of supplementary member calls other than PIA were classified in Tier 2 and 52% in Tier 3. The split was 40%-60% in most countries, except for two (DE, UK), where the amounts reported in Tier 2 were higher than the amounts reported in Tier 3.

3.20. Surplus funds were confirmed to exist in eight countries, totalling EUR 42 billion.

3.21. Significant amounts were reported in three countries (DE, DK, SE). In one of these countries (SE) for the undertakings that reported surplus funds in QIS4, 99% of own funds were surplus funds. This country noted that for undertakings with surplus funds it is of extreme importance that surplus funds were classified as Tier 1 funds, so they can be used in full to cover the Minimum Capital Requirement and the Solvency Capital Requirement. In another country (DE), surplus funds usually are determined as the amount of the current provision for bonuses and rebates that are not expected to be distributed to current policyholders. In a third country (DK), surplus funds as special bonus provisions have similar characteristics as equity.

3.22. Surplus funds may also be significant for certain insurers in other countries. In QIS4, two countries (BG, EL) reported a higher proportion of surplus funds to own funds compared to the average.

3.23. In the majority of these countries, surplus funds were reported in limited undertakings, though in terms of volume this represented only one quarter of total surplus funds. The remaining three quarters of surplus funds were held in mutuals and mutual type undertakings, reported in two countries.

3.1.2 Key issues

Lessons learned from the crisis

3.24. A key lesson learned from the crisis is that own funds must be available in times of stress to absorb losses. Own funds must be built up when undertakings are not in stress.

3.25. In terms of the Level 1 text, these are own fund items that *fully* possess the characteristic of permanent availability set out in point (a) of Article 93(1).

3.26. Article 94(1) requires Tier 1 own fund items to *substantially* possess this characteristic. Such Tier 1 own fund items are of a lower quality than own fund items that fully possess this characteristic.

3.27. This is particularly relevant for hybrid capital instruments that insurance and reinsurance undertakings have issued or will issue in the future.

3.28. Since the start of the crisis in August 2007, CEIOPS has observed that very few capital instruments that currently exist fully absorb losses in times of stress, other than ordinary share capital or the equivalent capital of mutual and mutual-type undertakings. For example, CEIOPS has observed virtually no deferral of interest on hybrid capital instruments. At the same time, CEIOPS has observed that dividends on ordinary shares have been reduced or withheld.

3.29. Another observation that CEIOPS has made in the crisis is that undertakings with a strong common equity base have, in general, been able to withstand the crisis better because they have held more own funds available in times of stress to absorb losses. Compared to banks insurance and reinsurance undertakings have, on the whole, issued hybrid capital instruments to a lesser degree and retained a higher proportion of earnings.

3.30. Hence, in addition to requiring Tier 1 to be the highest quality own funds, CEIOPS is of the view that the proportion of Tier 1 items in eligible own funds must be significantly higher than one third of the total amount of eligible own funds.

3.31. Compared to QIS4, putting CEIOPS' view set out at in the paragraph above into effect would mean increasing the average quality of own funds by:

- increasing the amount and quality of Tier 1;
- increasing the quality of Tier 2; and
- decreasing the amount, as well as increasing the quality, of Tier 3.

3.32. For Tier 1, two possible ways of achieving this would be as follows:

a) Restrict Tier 1 to ordinary share capital, or the equivalent capital of mutual and mutual-type undertakings, and reserves - the use of which is not restricted.

b) Restrict Tier 1 as in (a) above, plus hybrid capital instruments/ subordinated liabilities, provided they absorb losses first in a going concern. Such items could include, for example, automatically convertible instruments and instruments subject to write down as long as losses persist where conversion or write down would take place as and when the undertaking needs to absorb losses and in any case when the insurance or reinsurance undertaking breaches its Solvency Capital Requirement.

3.33. A number of CEIOPS Members are of the view that only ordinary share capital or the equivalent capital of mutual and mutual-type undertakings should be allowed in Tier 1, as far as capital instruments are concerned.

3.34. These Members do not consider other capital instruments to be of sufficient quality for classification in Tier 1. At the same time, these Members acknowledge that there may be merit in providing the possibility of classifying such other instruments in Tier 1 in exceptional circumstances, subject to those instruments meeting the necessary characteristics for eligibility as Tier 1 own funds. For example, recalling recent government intervention, this might be the case where capital market issuance is severely restricted or where this is needed in order to aid a recapitalization. The criteria for inclusion in these circumstances would need to be discussed and developed further and would need to be in line with the methods developed to approve items not covered by the list of own funds in accordance with Article 97 1 (b) (discussed below). Such a compromise approach could act as a counter-cyclical measure, as undertakings would be required to establish a strong capital base during good times and would not be able to grow their business using Tier 1 capital instruments that are of a lower quality. However in an economic downturn or where an undertaking is in a position of stress, there would be greater flexibility for consideration of other types of capital instruments such as mandatory convertible instruments or instruments that have a principal write-down on a trigger event recognizing that as an undertaking's position deteriorates further, higher quality capital would be generated through conversion or principal write-down. However CEIOPS notes that the European Commission prefers an approach where no distinction is made between economic circumstances for the classification of own fund items.

3.35. A number of other CEIOPS Members are of the view that hybrid capital instruments/subordinated liabilities can be included in Tier 1, provided they possess high-quality characteristics and features. For instance, these instruments should be available when needed due to a lock-in clause upon a breach of the SCR or where it can reasonably be foreseen by the supervisory authority or by the (re)insurance undertaking, as part of the ORSA, that a breach could occur within the next twelve months and redemption must be subject to supervisory approval.

3.36. These Members prefer to apply the same characteristics and features applicable to Tier 1 both in normal and in stressed circumstances as this would give undertakings a consistent view in assessing the overall solvency position. These Members point to the extended recovery period set forth in the Article 138(4) of the Level 1 text, i.e. in case of non compliance with the SCR and in the event of an exceptional fall in financial markets the supervisory authority can extend the period required for the re-establishment of the solvency position.

3.37. After due consideration of these issues and the responses from consultation, CEIOPS, acknowledges that there may be a role for high quality hybrids in Tier 1, provided that in stressed situations ie. breach of the SCR, they can convert or write down to provide higher quality capital in the form of equity. This addresses the view that higher quality capital could be generated during times of stress. At the same time, because it is not proposed that the characteristics of hybrids be weakened, undertakings will have a consistent view in assessing the overall solvency position.

3.38. CEIOPS cannot however, support any regime in which hybrid instruments could represent all or the most significant part of Tier 1. Any inclusion of high quality hybrids should therefore be restricted i.e. they should account for no more than 20% of Tier 1.

3.39. Within the context of these considerations, CEIOPS sees an inherent trade-off between the requirements for the quality of own funds eligible to cover capital requirements and the limit structure applicable to the tiers to which those own funds are allocated.

3.40. Therefore, it is not proposed that the limit for Tier 1 be lowered below 50%. This limit is supported by the majority as a reasonable position in light of the quality of capital within this tier. There is also a minority view expressed that a 60% limit would be appropriate.

3.41. This approach would be consistent with the ladder of intervention. However, it is acknowledged that the restriction applicable to Tier 1 will produce an additional gearing effect (i.e. the amount of hybrid instruments that will be counted as Tier 1 will rise and fall depending on the fluctuations caused by unrestricted Tier 1 (share capital and reserves)). The alternative is to limit hybrids by reference to a percentage of the SCR, but in the case of (re)insurers with a higher percentage of Tier 1 covering their SCR, they would be penalised from issuing additional hybrids due to the restriction against the SCR. This effectively penalises firms with better quality capital, which is counterintuitive.

3.42. CEIOPS also considered an alternative approach whereby hybrid instruments were considered to be eligible Tier 1 own funds for the purposes of the SCR, but coverage of the MCR was restricted to ordinary share capital; the equivalent capital of mutuals and reserves. However, it is not clear whether this would be consistent with the Level 1 text. In addition, the situation could arise where there is a breach of the MCR ahead of the SCR which would compromise the effective operation of the ladder of intervention and would result in hybrids representing the most significant part of Tier 1. This approach was rejected for these reasons.

3.43. Either way, CEIOPS interprets the requirement for loss absorbency in a going concern to mean that to be classified as Tier 1, capital instruments must be fully paid in. CEIOPS considers that while capital that has been called up but not paid in may provide sufficient loss absorbency in a winding up it is not fully available to absorb losses until it is paid in and is therefore not of sufficient quality to be considered Tier 1. As a consequence, called up but unpaid capital should be classified in Tier 2 or Tier 3, depending on the characteristics and features it possesses as set forth in Article 93.

3.44. CEIOPS recognizes that own funds that have been called up but not paid in will also be subject to a capital charge for counterparty risk, as is the case for other receivables which have not been paid in. The purpose of this requirement is to address the potential default risk and is still considered necessary even if the called-up capital is included in Tier 2. This is because counterparty default would also prevent capital absorbing losses in a winding-up.

3.45. In addition, for inclusion in own funds, CEIOPS is convinced that there should be certain minimum qualitative requirements for subordinated liabilities to be eligible for Tier 3, i.e. redemption should be subject to supervisory approval, they must be free from encumbrances and should have a minimum maturity. Without such a requirement subordination may not be effective and could be undermined. In particular, Tier 3 basic own funds should contribute towards avoiding insolvency as well as towards avoiding any acceleration towards insolvency.

3.46. CEIOPS' aim to improve the quality of Tier 1 own funds is consistent with various initiatives that are currently underway in relation to the banking regime to review the definition of own funds. CEIOPS considers it more important to be consistent with the direction of travel than with the current rules on own funds for banks.

Proposed limit structure

3.47. The Level 1 text requires quantitative limits to be set for the components of own funds that are eligible to cover the Solvency Capital Requirement and the Minimum Capital Requirement in implementing measures.

3.48. The limits in the Level 1 text act as a backstop to these implementing measures. This approach was adopted to reflect the growing consensus at the Level 1 negotiations that the amount of Tier 1 needed to be increased.

3.49. The impact assessment for the proposed limit structure is annexed to this advice.

3.50. CEIOPS recommends that the limit structure is set so as to ensure that:

- in relation to compliance with the Solvency Capital Requirement the proportion of Tier 1 is greater than the proportion of eligible Tier 2 and that the proportion of eligible Tier 2 is greater than the proportion of eligible Tier 3; Tier 3 may be included (subject to the limits), regardless of whether undertakings have Tier 2 eligible own funds or not;
- in relation to compliance with the Minimum Capital Requirement, the proportion of Tier 1 is greater than the proportion of eligible Tier 2 basic own funds.

3.51. CEIOPS also recommends that, as far as the compliance with the Solvency Capital Requirement is concerned:

- the proportion of Tier 1 items in eligible own funds is at least 50% of the total amount of eligible own funds (a minority of CEIOPS Members have expressed a preference for at least 60%), and
- the proportion of Tier 3 items in eligible own funds is set at a maximum of 15% of the total amount of eligible own funds. This percentage is considered appropriate due to the characteristics relating to the quality of capital required for elements to be included in Tier 3, taking into account the requirements proposed in this advice (see paragraphs 3.64 and 3.137 to 3.145).

3.52. CEIOPS interprets the term eligible own funds as own funds that count towards covering the Solvency Capital Requirement and the Minimum Capital Requirement, subject to the framework of the limit structure.

3.53. Tier 1 own funds and tier 2 basic own funds are part of eligible own funds.

3.54. Tier 3 basic own funds eligible to cover the Solvency Capital Requirement, but not eligible to cover the Minimum Capital Requirement.

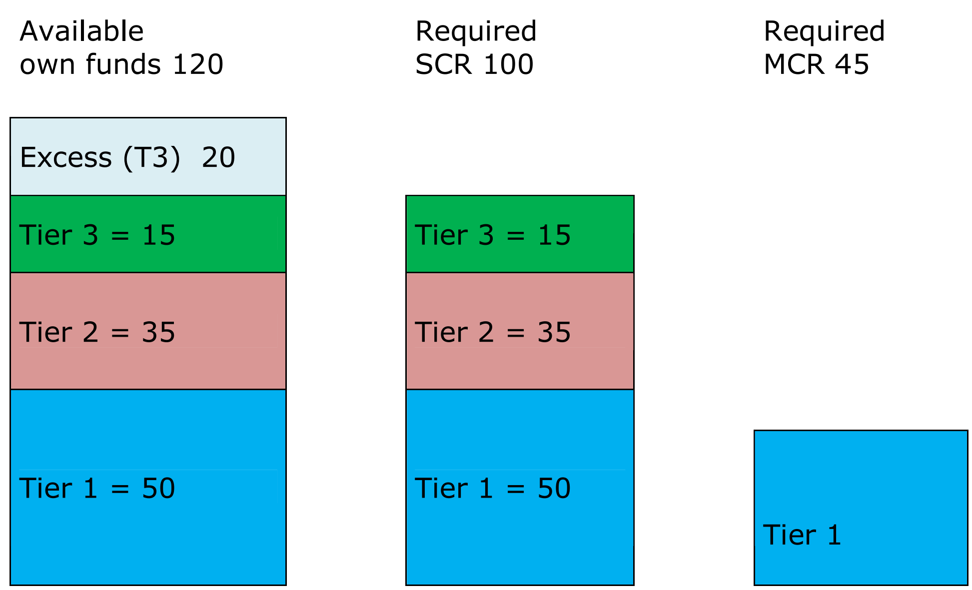
3.55. Ancillary own funds are eligible to cover the Solvency Capital Requirement, but not eligible to cover the Minimum Capital Requirement.

3.56. With regards to the comments made by the industry, CEIOPS does not consider that convincing arguments have been put forward as to why the proposed limits are inappropriate, given the need for the SCR and the MCR to be met with own funds of an appropriate quality, so it proposes to retain the limits set out above.

3.57. In addition, CEIOPS considers that the calculation methods for the MCR and the SCR are sufficiently clear for the limits to be established.

3.58. Considering the corridor for the computation of the Minimum Capital Requirement, this results in a proportion of Tier 1 items in eligible own funds that fully covers the total amount of eligible own funds, as far as the compliance with the Minimum Capital Requirement is concerned.

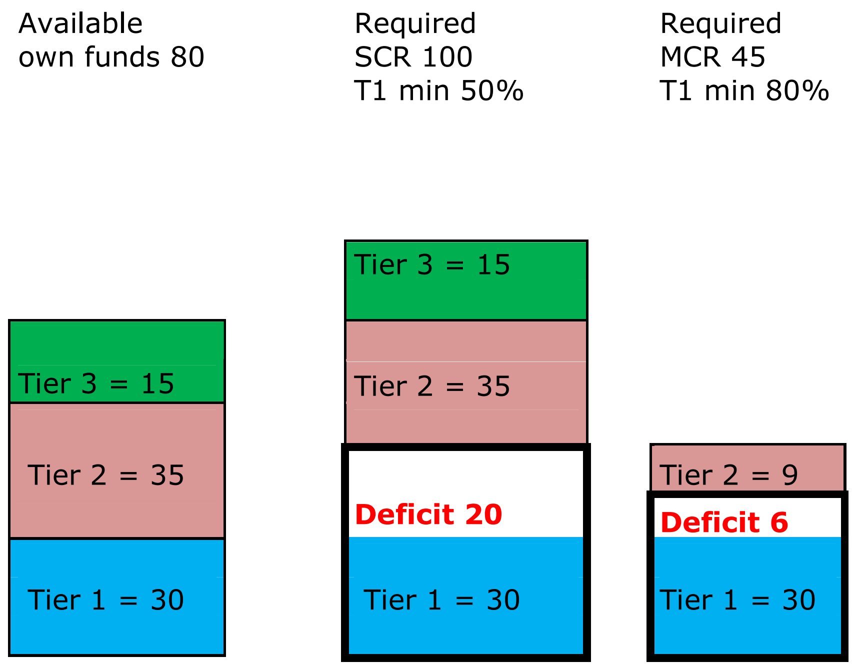
3.59. The following example, based on an SCR coverage of Tier 1 – 50%, Tier 2 – 35% and Tier 3 – 15%, illustrates this.[5]



3.60. On the other hand, setting the limit for the MCR coverage to 100% T1 would not ensure that the supervisory ladder of intervention is maintained and would result in the SCR and MCR being breached simultaneously.

3.61. CEIOPS believes that T1 should be 80% of the MCR, which it considers an appropriate level to allow for a sufficient ladder of intervention. Indeed, taking into consideration the corridor, the simultaneous breach of SCR and MCR would happen only if T1 falls below 36% of SCR (greater than one third). See example below.

[5] This example relates only to Tier 1.



Minimum characteristics for own funds

3.62. The Level 1 text defines basic owns funds as the excess of assets over liabilities and subordinated liabilities. Therefore, for a liability to be included within own funds it must be at a minimum subordinated to all claims of policyholders and all other senior creditors.

3.63. Article 94 states that any basic and ancillary own funds that do not fall into paragraphs (1) and (2) of Article 94 should be classified as Tier 3. At the same time, the Level 1 text does not stipulate which of the characteristics and features in Article 93, if any, Tier 3 subordinated liabilities must display.

3.64. CEIOPS recommends that Tier 3 basic own funds demonstrate features to ensure that subordination is effective and not just a nominal requirement. Subordination would not be effective, and would be undermined, if Tier 3 basic own funds were freely redeemable (therefore redemption should be subject to supervisory approval), or coupons on Tier 3 basic own funds were freely payable when an undertaking's solvency position is deteriorating or is foreseen to deteriorate.

3.65. CEIOPS also recommends that providers of own funds are not permitted to cause an undertaking to become insolvent, nor should they be permitted to be in a position to accelerate the insolvency of the undertaking, because permitting this would be contrary to the principle of policyholder/beneficiary protection.

3.66. Also, CEIOPS recommends that any redemption, conversion or exchange of capital instruments, including any premiums paid in on those instruments, is subject to prior supervisory approval, without which subordination may not be effective, and could be undermined.

3.67. These recommendations are consistent with the direction of travel of prudential regulation of the banking industry.

Sufficient duration

3.68. Article 93.2 requires that, when assessing the extent to which own fund items possess the characteristics set out in points (a) and (b) in Article 93.1, currently and in the future, due consideration shall be given to the duration of the item, in particular whether the item is dated or not. Where an own fund item is dated, the relative duration of the item as compared to the duration of the insurance and reinsurance obligations of the undertaking shall be considered (sufficient duration).

3.69. On the basis of this requirement, in QIS4, CEIOPS tested whether capital instruments should be included in own funds on the basis of their issue date or their reporting date. The results of the exercise were not conclusive, largely due to the lack of comprehensive feedback from participants.

3.70. Since QIS4, the discussions in CEIOPS on how to address the sufficient duration feature have evolved.

3.71. CEIOPS considers that an issue date basis would provide an appropriate framework, based on the following conclusions that CEIOPS has drawn in relation to own funds from a broader perspective.

- For inclusion in own funds, capital instruments must not be freely redeemable, or coupons freely payable[6], when an undertaking's solvency position is deteriorating, or is foreseen to deteriorate. They must be available when needed through the exercise of a lock-in clause at least upon a breach of the SCR, and redemption must be subject to supervisory approval.
- The redemption date is considered to be the first contractual opportunity to redeem the instrument, which would mean either the maturity date or the first call date.
- Tier 1 should not include capital instruments with an incentive to redeem (as defined in paragraph 3.84(iv) hereunder).
- Tier 3 capital instruments should have a minimum maturity of 3 years at issue date.

3.72. In QIS4, the minimum maturity at issue date for Tier 1 was set at 10 years and for Tier 2 at 5 years. In general, this worked well.

3.73. CEIOPS is sensitive to stakeholders' views that the concept of matching the duration of the capital instruments against the duration of the liabilities may result in difficulties, particularly when the duration for certain liabilities is unknown and should the duration of the liabilities change significantly over time. Nonetheless it is important that issuers take into account the maturity profile of their liabilities in order to have in place adequate capital management plans, and to ensure consistency with the Level 1 text.

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[6] Not freely redeemable and not freely payable in this context should be taken to mean that any cash outflows are subject to prior supervisory approval.

3.74. With this in mind, CEIOPS recommends that the minimum maturity at issue date should be:

10 years for Tier 1,

5 years for Tier 2,

3 years for Tier 3

3.75. The combination of safeguards arising from the proposed restrictions on the amount of hybrids and the criteria as to their quality as well as the features of capital instruments in Tier 1, 2 and 3, means that CEIOPS is satisfied that the sufficient duration of own funds instruments called for by the Level 1 text can be achieved through the benchmark minimum maturities proposed i.e. 10 years for T1, 5 years for T2, and 3 years for T3.

3.76. The duration of the capital instrument is defined as the first contractual possibility of repayment. When determining duration, the time horizon must be the expected duration, or anticipated duration over the next twelve months.

3.77. More broadly, within the issue date approach, there should be a general principle that the average duration of capital instruments should not be significantly lower than the average duration of an undertaking's liabilities. With this in mind, the undertaking should be required to assess the sufficient duration of own fund items as part of its risk management. CEIOPS suggests that this assessment would be part of the ORSA and the supervisory review process.

3.1.3 Basic own funds

a) Tier 1 requirements

Capital instruments

3.78. Unlike own funds that an undertaking generates as part of its ongoing business activities, raising own funds involves issuing capital instruments to investors (including to an entity within a group) who assume risk in return for yield.

3.79. In determining whether a Tier 1 own fund item is loss absorbent in a going concern and in a winding-up, Article 93 requires, in addition to the characteristics of permanent availability and subordination, the following features to be taken into consideration:

- sufficient duration;
- free from requirements/incentives to redeem the instrument;
- absence of mandatory fixed charges; and
- absence of encumbrances.

3.80. Tier 1 is one of the key measures that both supervisory authorities and the markets use to determine an undertaking's capital adequacy. This reinforces the need to ensure that own fund items included in Tier 1 are of the highest quality and demonstrably absorb unexpected losses to enable an undertaking to continue as a going concern.

3.81. In the context of capital instruments, the own fund item that unequivocally meets this test is ordinary share capital or the equivalent capital of mutual and mutual-type undertakings. The reason that this type of own fund item is considered to be the best quality is that it:

- absorbs losses before all other capital instruments;
- absorbs losses as and when they occur; and
- ranks below all other capital instruments in a liquidation.

3.82. This type of capital absorbs the first loss because there is no preference as to either income or return on capital. Where own fund items have a preference with respect to either coupon payments or repayment of principal, the capital is less loss absorbent than ordinary shares.

3.83. The deepest subordination of Tier 1 could provide a distinction in the quality of own funds in a going concern. For example, it could reinforce the perceived solidity of an undertaking's capital and enhance confidence in the undertaking, which could facilitate raising capital when access to capital markets is restricted. Deepest subordination is consistent with the requirement for Tier 1 to be loss absorbent on a going concern basis as the level of subordination is closely linked to the appetite of investors to absorb losses. For example, Tier 1 instruments that rank above ordinary shares will not take losses until common equity has been exhausted. Deepest subordination for Tier 1 would also be in line with developments in the banking regime. Despite the fact that deepest subordination represents an additional cost to the (re)insurance undertaking, the inclusion of hybrid instruments within Tier 1, means that there exists an additional buffer of eligible own funds for policy holders and senior creditors to rely upon to absorb losses in a winding up situation. Against this background, CEIOPS believes that all Tier 1 instruments should be the most deeply subordinated in a winding-up.

3.84. Therefore, consistent with a rigorous definition of *substantially loss absorbent*, Tier 1 own funds should display the following key features:

i. **Subordination:** the item must be the most deeply subordinated in a winding-up.

ii. **Loss absorbency:** the item must be fully paid in, must be the first instrument to absorb losses or rank *pari passu* with an instrument that substantially absorbs first losses, and must not hinder recapitalization.

iii. **Sufficient duration:** the item should not have a legal maturity of less than 10 years at issue date. The item must be contractually locked-in on a breach of the Solvency Capital Requirement where redemption is only permitted in exceptional circumstances, if the item is replaced by an own fund item of equivalent or higher quality and subject to the consent of the supervisory authority.

iv. **Free from requirements or incentives to redeem:** there must be no incentives to redeem the item. An incentive to redeem is a feature which in conjunction with a call would make the undertaking more likely to redeem the instrument. The item must only be redeemable at the option of the undertaking (i.e. not at the option of the holder) and any redemption should be subject to the approval of the supervisory authority.

v. **Free from mandatory fixed charges:** at all times coupons/dividends must be able to be cancelled and must at a minimum be cancelled on a breach of the Solvency Capital Requirement after which they can only be paid in exceptional circumstances and subject to the consent of the supervisory authority. Undertakings should have full discretion over the amount of payment; coupons/dividends must not be at a fixed rate and there should be no preference as to income or return of capital. CEIOPS maintains its view that an MCR based trigger would be ineffective given than an MCR breach results in ultimate supervisory action. Any trigger between the MCR and the SCR would create an additional level for the undertaking to monitor and would not be consistent with the Level 1 text. A trigger based on the SCR is therefore needed to ensure that action is taken sufficiently early to maintain the undertaking as a going concern.

vi. **Absence of encumbrances:** the instrument must be free from encumbrances and therefore should not be connected with any other transaction which, when considered with the own fund item, could undermine the characteristics of that item. Examples of potential encumbrances include, but are not limited to, rights of set off, restrictions, charges or guarantees. Where an investor subscribes for capital in an undertaking and at the same time that undertaking has provided financing to the investor, only the net financing provided by the investor is considered as eligible own funds.

<u>Other own fund items</u>

References in the Level 1 text

3.85. The Level 1 text refers to the 'excess of assets over liabilities' in three places: recital 48, recital 49 and Article 88. In particular, Article 88 states that the 'excess of assets over liabilities' shall be considered as basic own funds.

3.86. The Level 1 text makes no explicit reference to how the 'excess of assets over liabilities' should be classified. Article 93 mentions the characteristics and features that shall be used to classify own funds into tiers.

3.87. In this connection, CEIOPS notes that the Level 1 text does not provide a definition for 'assets' or 'liabilities', leaving the meaning of the excess of assets over liabilities open. CEIOPS' advice on the valuation of assets and liabilities (other than technical provisions) relies on the same definitions for assets and liabilities as those used for accounting purposes as the use of a substantially different definition does not seem the intention of the Level 1 text (see for example Recital 46: Valuation standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings.).[7]

[7] Former CP 35. See http://www.ceiops.eu/index.php?option=content&task=view&id=583.

3.88. In order to analyse how to develop implementing measures in this respect, CEIOPS notes in the Level 1 text that:

a. the '*excess of assets over liabilities*' shall be classified as '*basic own funds'* (Article 88),

b. '*basic own funds'* shall be reduced by the amount of own shares held by the insurance or reinsurance undertaking (Article 88). According to the principle of substance over form, CEIOPS believes that where there is evidence of a group of connected transactions whose economic effect is the same as the holding of *'own shares'*, the assets that those transactions generate for the undertaking shall be deducted from its own funds, to the extent necessary to guarantee that own funds reliably represent the net financial position of its shareholders, further to other allowed items.

c. '*basic own funds*' not classified as Tier 1 or Tier 2, shall be classified as Tier 3 (Article 94.3).

3.89. Recital 48 states the following in relation to the classification of the *'excess of assets over liabilities'* into tiers:

Generally, assets which are free from any foreseeable liabilities, are available to absorb losses due to adverse business fluctuations, both on a going-concern basis as well as in the case of winding-up. Therefore the vast majority of the excess of assets over liabilities, as valued in accordance with the principles set out in this Level 1 text, should be treated as high quality capital (Tier 1).

3.90. Recital 48 in conjunction with articles 88, 93 and 94, show that the Level 1 text recognizes that not all elements of the 'excess of assets over liabilities' necessarily meet the requirements of Article 94.1 to be classified as Tier 1. Consequently, although a *'vast majority'* (as expressed in recital 48) of elements meet such requirements, some elements may not.

3.91. In other words, when classifying elements of the excess of assets over liabilities into tiers, differences in their loss-absorption capacity has to be taken into consideration to comply with the Level 1 text. CEIOPS notes that in this regard there may be some conflict between Solvency 2 requirements and restrictions or requirements created under national law.

3.92. The European Commission has indicated to CEIOPS that its interpretation of the Level 1 text is that once assets and liabilities are valued under article 75, the net arithmetical result constitutes own funds. The own funds articles merely require classification into tiers and do not permit any item to be excluded or the amount at which it is recognised adjusted on the grounds of lack of quality eg availability and/or loss absorbency.

3.93. This interpretation was not the understanding of CEIOPS members at the time the Level 1 text was developed. The advice set out in the consultation paper was drawn up on the basis that potential own funds items need to be assessed firstly to establish whether they have the necessary quality to be eligible as own funds and secondly allocated to tiers having regard to their particular characteristics. There is a clear distinction between the valuation of particular items on an economic basis and the extent to which they can properly contribute to capital available to meet the risks arising in a (re)insurance undertaking. CEIOPS remains of the view that the approach adopted in the consultation paper is necessary to deliver a prudentially sound regime for own funds under Solvency II. CEIOPS also notes the importance of cross-sectoral consistency and considers there are no sound reasons for there to be an inconsistent approach. This is particularly the case given international consensus confirmed by the G20 on the importance of the quality of capital in the financial services sector.

3.94. In the advice which follows the consultation CEIOPS has indicated where it considers items should be restricted in their inclusion in own funds in accordance with the above. However recognising the position of the Commission CEIOPS has also indicated treatments which may satisfy the alternative interpretation put forward by the Commission. In most cases this involves classifying items in tier 3 and/or introducing an appropriate risk charge.

3.95. CEIOPS has identified elements of the 'excess of assets over liabilities' with restricted loss-absorption capacity either on a going-concern basis or in the case of winding-up and has analysed these characteristics separately[8] for classification into tiers. Among others:

a. Reserves, the use of which is restricted.

b. The difference between the value of technical provisions calculated in accordance with Articles 75 to 86 - that is, on a going concern basis - and the amounts that the original undertaking shall have to pay to its policyholders to honour their rights according to the contracts in force in the case of winding up with no transfer of portfolios is known as the "winding-up gap" where such a difference exists. This calculation shall allow for the amounts that policyholders are legally or contractually obliged to pay to the undertaking in a situation of winding up. The existence of this winding up gap would depend for every contract on the link between the policyholders' rights when the contract is cancelled in winding up and the technical provisions calculated by the undertaking.

c. Deferred tax assets.

d. Intangible assets[9].

3.96. To comply with the Level 1 text, including recitals 48 and 49, CEIOPS considers that elements of the 'excess' which do not meet the requirements of Article 94.1 to be classified as Tier 1 should be classified in a lower tier or restricted as to their inclusion in own funds, where classification would be based on an assessment against the criteria set forth in Article 93.

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8 Ring-fenced funds are not considered in this list, as they will be the subject of a separate consultation in the third set of advice. For the analysis of elements other than ring-fenced funds, we note that ring-fenced funds are mentioned in recital 29b in the following terms: Not all assets within an undertaking are unrestricted. In some Member States, specific products origin some ring-fenced fund structures which give one class of policyholders' greater rights to assets within their own "fund". Although these assets are included in computing the excess of assets over liabilities for own-funds purposes they cannot, in fact be made available to meet the risks outside the ring-fenced fund. To be consistent with the economic approach, the assessment of own-funds needs to be adjusted to reflect the different nature of assets, which form part of a ring-fenced arrangement. Similarly the SCR calculation should reflect the reduction in pooling/diversification related to those ring fenced funds.

9 Former CP 35 on Valuation of Assets and "Other Liabilities"' suggested that the valuation of certain intangibles, such as goodwill to be at nil. If intangibles are valued at nil in the Solvency 2 balance sheet no additional treatment is necessary from an own funds perspective. Mentioned previously.

3.97. CEIOPS reads Article 93 to mean that the loss-absorption capacity of an item requires the capacity to absorb any type of losses (wherever they arise in the undertaking's business), regardless of the solvency position of the undertaking (assuming the undertaking is able to continue its business or enters into winding up, whether it can, or cannot, transfer its portfolios of contracts and assets).

3.98. This approach has the merit of guaranteeing that no item with restricted or limited loss-absorption capacity is classified as own funds or Tier 1 as appropriate), which appears to be the aim of Article 94 and recital 48.

3.99. The consequences of this approach may be summarized as follows:

a) Reserves, the use of which is restricted

3.100. These should only be eligible for inclusion in own funds in relation to the risks they cover. (CEIOPS' preferred option) Some CEIOPS Members consider this approach to be similar to the approach adopted for ring-fenced funds in QIS4.

3.101. As explained in paragraph 3.94 an alternative approach to meet the Commission interpretation is that all reserves should be compared with the key features for T1 and T2; restricted reserves should move to Tier 3 if these features are not met.

b) Winding up gap (for further background see Annex A).

3.102. The Level 1 Text recognises that the elements of the excess of assets over liabilities can have diverse levels of loss absorption capacity; therefore this has to be taken into account when classifying them into tiers. The loss-absorption capacity of an item requires the capacity to absorb losses on a going and gone concern. Given that the winding up gap lacks loss absorption capacity, in the case of winding up where there is no transfer of portfolios, this item is neither available to absorb losses in a going-concern basis nor in the case of a winding-up, and consequently, it does not possess the characteristic set forth in Article 93.1a for classification as Tier 1. The winding-up gap, by definition, will be paid to the policyholders in the case of winding-up. Consequently, it does not possess the characteristics set forth in Article 93.1b for classification as Tier 2. According to the Level 1 Text, own funds items which do not possess the characteristics and features to be classified as Tier 1 or Tier 2, shall be classified as Tier 3.

3.103. The proposed treatment for this item is an immediate consequence of the principles set out in Articles 93 and 94 of the Level 1 text. While Article 88 of the Level 1 text sets out clearly an automatic recognition as eligible basic own funds of the excess of assets over liabilities, at the same time Article 94(2)(3) explicitly recognizes that items of basic own funds should be tested against the criteria set out in Article 93. These criteria also set out explicitly that Solvency II aims to protect policyholders' rights both in a going concern and winding up. Furthermore, as in Solvency I, Solvency II aims to guarantee policyholders' rights both when the portfolio of contracts of the undertaking in difficulties may be transferred and in those situations where such transfer is not possible due market conditions, as occurred in the recent crisis. This important issue for consumers should be respected in the assessment of the quality of own funds and their classification into tiers.

3.104. As already stated in this advice, CEIOPS is committed to achieving the aim of high quality capital that is measured according its loss-absorbency capacity in a going concern as well as a winding up. CEIOPS thinks this is the consistent way to proceed according to the Level 1 text, which explicitly recognises the distinct quality of different own funds items by requiring classification into three tiers. Articles 93 and 94 should be applied in such a manner that items of own funds are considered as high-quality capital only when they substantially absorb losses in all of the situations where it is necessary to protect policyholders' rights.

3.105. CEIOPS recognises that the winding up gap is not applicable in all jurisdictions and contracts.

c) Deferred tax assets

3.106. CEIOPS is of the view that the Level 1 text is unclear on the treatment of deferred tax in general, i.e. both deferred tax assets and deferred tax liabilities. It is also a complex issue which is linked to the SCR, valuation[10], fungibility/transferability and accounting.

3.107. Any treatment of deferred tax assets in own funds would necessarily depend on the general approach to deferred tax.

3.108. On the basis that deferred tax will be calculated on the entire solvency balance sheet, and considering that deferred tax assets are assets of a contingent nature representing losses that can be offset against future taxable profits, CEIOPS considers that deferred tax assets could be treated in one of two ways.

3.109. Underlying both options is the consideration that, as the solvency position of an undertaking deteriorates, the accounting value of deferred tax assets rises, while their economic value falls. Recognising such assets in full appears contradictory to the aim of the solvency balance sheet. Also, care should be taken to avoid counting the benefit of deductible tax losses twice in the assessment of the solvency position of undertakings. If deferred tax assets are recognised as having some loss absorbing capacity, they increase the value of assets, thereby the excess of assets over liabilities and thereby the value of basic own funds used to cover the Solvency Capital Requirement; while when calculating the Solvency Capital Requirement using the standard formula, the SCR of an undertaking can be decreased for the loss-absorbing capacity of deferred taxes.

3.110. The two approaches can be described as follows:

[10] The issue of valuation of deferred tax is set out in CEIOPS-DOC-31/09 mentioned previously.

- The assets do not absorb losses in a going concern or in a winding up and should be excluded entirely from own funds (apart from the amount expected to be used in the next twelve months or unless they can be transferred to another entity – in accordance with the relevant tax legislation): as the realisation of deferred tax assets is dependent on future taxable income, they are of limited value for the undertaking in terms of their ability to absorb losses in times of stress/deficits or in a winding-up.
- The assets may have limited loss absorbing capacity: The realisation of deferred tax assets depends on making the relevant future taxable income and have a zero value on winding up unless they can be transferred to another entity. Therefore, apart from the amount expected to be used in the next twelve months, unless they can be transferred to another entity – in accordance with the relevant tax legislation – they should be classified in Tier 3.

d) Intangible assets

3.111.To the extent that intangible assets, other than goodwill, have been purchased, and can be readily resold, they should be treated as any other asset, to the extent that they are subject to a capital charge. Intangible assets not valued at zero and not subject to a capital charge should be excluded from own funds.

3.112.If this is not deemed possible in line with the Commission's interpretation, intangible assets should be regarded as Tier 3. However in this case, in order to ensure that the risks attaching to intangible assets are addressed CEIOPS recommends the introduction of an intangible asset risk module in the SCR standard formula. A detailed explanation underpinning this proposal is set out in Annex B.

Expected future profits

3.113.This advice described the need for further analysis in respect of the item then called '*profits at inception*'. This expression was used to facilitate the consultation process, since its meaning is widely understood in the insurance industry. Nevertheless, in order to provide advice more appropriate for a legal text, from this point on this item will be referred to as '*expected future profits*'.

3.114.The following paragraphs reflect the output of the further analysis carried out by CEIOPS, where comments from stakeholders, resulting from the consultation process, have been considered carefully.

3.115.'*Expected future profits*' are defined as the actual value of any type of profit included, either explicit or implicitly, in the future inflows considered in the calculation of the best estimate.

3.116.According to the provisions set out in articles 75 to 85, the '*expected future profits*', contribute to the excess of assets over liabilities and therefore they are an element of the basic own funds. The Level 1 text requires testing of this item, as any other, against the loss-absorbency criteria set out in articles 93 and 94.

3.117. Solvency II aims to guarantee a 99.5 per cent confidence level, protecting policyholders' rights where there is a transfer of the business of the undertaking in difficulties, even in circumstances where such a transfer is problematic. Where this is the case to the extent that the transfer is not possible '*expected future profits*' represents an item with no capacity for loss absorption.

3.118. In case of negative deviations in the insurance business, proceeding from the actuarial assumptions underlying the calculation of technical provisions, and therefore underlying the amount of 'expected future profits', it is clear that the SCR provides the adequate protection at the targeted level of confidence.

3.119. Nevertheless in case of negative deviations proceeding from other sources (i.e. operational risk, market risks or counterparty default risks), the item corresponding *'expected future profits'* does not provide funds available to absorb the losses, unless the portfolio is transferred. And this lack of protection applies both in going concern and in case of termination of the activity.

3.120. If *'expected future profits'* is allowed to be counted as a tier 1 item, an insurance undertaking could hold 100% of its own funds in the form of this item. This does not protect policyholders' rights, since the undertaking would not hold own funds to face any deviation derived from the sources mentioned in the previous paragraph if it fails in transferring the insurance portfolio *('expected future profits'* are not actually available funds to face losses due to, i.e. market falls or defaults of counterparties if the portfolio is not transferred).

3.121. In this respect and in light of the recent crisis, CEIOPS has observed that there is a direct link between financial crises and tightening of market conditions to transfer portfolios. In other words, in situations of financial crisis (where negative deviations mentioned in 3.7 are frequent), transfers of portfolio are more uncertain and at the same time the own funds held as *'expected future profits'* will display no loss absorption capacity. This exposes undertakings in difficult situations to failure in honouring their commitments.

3.122. Having in mind this legal and technical rationale, CEIOPS has concluded that classifying *'expected future profits'* as tier 3, is the more appropriate and legally necessary solution according to article 94(3) as this item does not possess the characteristics necessary to be considered as tier 1 or 2. However insurance contracts which are subject to consideration under the winding up gap may also give rise to expected future profits. Where this is the case there should be no double-counting of the amount excluded from Tier 1 and classified as Tier 3

3.123. In terms of the impact of this advice based on the Level 1 text, CEIOPS notes that Solvency I only allows future profits for life insurance business under restrictive requirements. These profits currently represent a very limited proportion of own funds.

3.124. Conversely, Solvency II expands the allowance of *'expected future* profits' to any type of insurance business (therefore, life, non-life and health).

3.125. Finally and considering cross-border consistency and effects, at least two considerations seem relevant. Firstly, an allowance of this item as tier 1 might have significant consequences endangering a level playing field among sufficiently similar cross-border activities. In the same line, expanding an allowance as tier 1 of this *'expected future profits'* to other financial sectors would likely undermine the current efforts to foster the stability of the financial system.

b) Tier 2 requirements

3.126. In accordance with Article 94.2, basic own fund items are classified in Tier 2 where they substantially possess the characteristic set out in point (b) of Article 93.1, taking into consideration the features set out in Article 93.2.

3.127. In determining whether a Tier 2 own fund item is loss absorbent in a winding-up, Article 93 requires, in addition to the characteristics of subordination, the following features to be taken into consideration:

- sufficient duration;
- free from requirements/ incentives to redeem the instrument;
- absence of mandatory fixed charges; and
- absence of encumbrances.

3.128. Tier 2 basic own funds are the second line of defence after Tier 1, and need to absorb losses when Tier 1 is depleted.

3.129. As such, they can be of a lower quality than Tier 1. At the same time, they should absorb losses to a greater degree than Tier 3 basic own funds.

3.130. When an undertaking's solvency position is not deteriorating, or is not expected to deteriorate, Tier 2 basic own funds can provide a cheaper source of finance than Tier 1.

3.131. However, overreliance on Tier 2 basic own funds could cause refinancing problems for an undertaking when it needs financing, unless the funds can convert into Tier 1 upon a trigger event.

3.132. Therefore, a balanced approach to Tier 2 basic own funds appears appropriate.

3.133. Tier 2 basic own funds do not need to absorb the first loss. So, preference with respect to return on capital may be allowed. The repayment of principal may be allowed as long as the Solvency Capital Requirement is not breached.

3.134. Coupon payments must also be deferred when the Solvency Capital Requirement is breached. This is to ensure that the payments on capital instruments do not accelerate insolvency, which would limit the ability of Tier 2 to absorb losses.

3.135. Given that the Level 1 text does not require Tier 2 basic own funds to be substantially loss absorbent in a going concern, requiring deeper subordination than Tier 3 basic own funds does not appear necessary, or relevant.

3.136. In view of the considerations set forth above, Tier 2 basic own funds should display the following key features:

vii. **Subordination:** the item must be effectively subordinated in a winding-up.

viii. **Loss absorbency:** the item does not need to be fully paid in, but can simply be called up, and must absorb losses to a degree. The undertaking must be able to defer coupon payments once the SCR has been breached.

ix. **Sufficient duration:** the item should not have a legal maturity of less than 5 years at issue date. The item must be contractually locked-in on a breach of the Solvency Capital Requirement where redemption is only permitted if the item is replaced by an own fund item of equivalent or higher quality and subject to the consent of the supervisory authority.

x. **Free from requirements or incentives to redeem:** there may be moderate[11] incentives to redeem the item. The item must only be redeemable at the option of the undertaking (i.e. not at the option of the holder) and any redemption should be subject to the approval of the supervisory authority.

xi. **Free from mandatory fixed charges:** coupons/dividends must at a minimum be deferred for an indefinite term on a breach of the Solvency Capital Requirement after which they can only be paid subject to the consent of the supervisory authority.

xii. **Absence of encumbrances:** the instrument must be free from encumbrances and therefore should not be connected with any other transaction which, when considered with the own fund item, could undermine the characteristics of that item. Examples of potential encumbrances include, but are not limited to, rights of set off, restrictions, charges or guarantees. Where an investor subscribes for capital in an undertaking and at the same time that undertaking has provided financing to the investor, only the net financing provided by the investor is considered as eligible own funds.

c) Tier 3 requirements

3.137. The role of Tier 3 basic own funds is to provide loss absorbency in a winding up in order to adequately protect policyholders and beneficiaries. This is particularly important as Tier 3 can represent a very substantial proportion of the undertaking's own funds unless its eligibility is limited.

3.138. Article 94 does not require Tier 3 basic own funds to *substantially* possess the characteristics in Article 93, full loss absorbency on a going concern basis and full loss absorbency in a winding up taking into consideration the features of absence of incentives to redeem, mandatory fixed charges and encumbrances. However, while Article 94 does not require Tier 3 to substantially possess these characteristics, it does not require the characteristics and features to be disregarded altogether.

[11] What incentives would be permissible will need to be developed further in Level 3 supervisory guidance.

3.139.Tier 3 capital instruments should possess at least some of the characteristics and features required for Tier 1 and Tier 2 eligibility, but to a lesser degree.

3.140.It is clear that Tier 3 capital instruments must be subordinated by virtue of Article 87. The purpose of subordination is to ensure that own funds function effectively and absorb losses in the case of winding up or insolvency. In order for subordination to be effective, the own fund item must in fact be available on winding up. Tier 3 capital instruments should therefore be prevented from having characteristics and features that undermine this.

3.141.If Tier 3 capital instruments are encumbered in any way this may undermine the effective subordination of that item and may result in the claims of capital holders being senior to policyholders.

3.142.Therefore, in addition to subordination Tier 3 capital instruments must be free from encumbrances. There should be no redemption of Tier 3 capital instruments, or coupon payments, on a breach of the Solvency Capital Requirement (i.e. during the ladder of supervisory intervention), unless the supervisory authority determines that redemption is necessary to facilitate a recapitalisation. Similarly, Tier 3 capital instruments should have a minimum maturity (e.g. 3 years). This would increase the likelihood the Tier 3 capital instrument will be present for a reasonable period and available in a winding-up or insolvency. The shorter the maturity of an instrument the less likely this becomes.

3.143.The features suggested above are designed to ensure as far as possible that there is a harmonised interpretation of what features a subordinated liability should display in order to be included in own funds for Solvency 2 purposes.

3.144.Tier 3 capital instruments could also include features which could push the insurance or reinsurance undertaking into insolvency. CEIOPS concludes that there should be an overarching principle that no own funds items are allowed to cause, or accelerate, an undertaking to go into insolvency. In the case of Tier 3 capital instruments, preventing redemption after a breach of the Solvency Capital Requirement (i.e. a lock-in) and stopping the payment of coupons once the Solvency Capital Requirement is breached, are both important features in achieving this. To be eligible own funds CEIOPS is of the view that all cash flows on own fund items (i.e. both coupon and principal payments) should be subject to supervisory approval once the Solvency Capital Requirement is breached.

3.145.QIS 4 did not specify any characteristics for Tier 3 capital instruments (apart from subordination). However, for the reasons set out above CEIOPS recommends that the implementing measures require certain features for Tier 3 capital instruments to ensure effective subordination and to ensure that own fund items do not cause or accelerate insolvency.

3.1.4 Ancillary own funds

<u>*a) Tier 2 requirements*</u>

3.146. Ancillary own funds are own funds that can be called up to absorb losses. For classification in Tier 2, ancillary own fund items must be callable on demand to absorb losses on a going-concern basis, as well as in a winding-up.

3.147. In determining whether a Tier 2 ancillary own fund item is loss absorbent in a going concern and in a winding-up, Article 93 requires, in addition to the characteristics of permanent availability and subordination, the following features to be taken into consideration:

- sufficient duration;
- free from requirements/incentives to redeem the instrument;
- absence of mandatory fixed charges; and
- absence of encumbrances.

3.148. In line with CEIOPS advice on Tier 1, ancillary own fund items classified in Tier 2 should be callable own funds of the highest quality and demonstrably absorb unexpected losses to enable an undertaking to continue as a going concern.

3.149. Unless otherwise stated in the Level 1 text, CEIOPS is of the view that, for classification in Tier 2, ancillary own fund items should represent own fund items which, if called up and paid in, would be classified in Tier 1.

3.150. Accordingly, ordinary share capital or the equivalent capital of mutual and mutual-type undertakings that can be called up would be classified in Tier 2.

3.151. Hybrid capital instruments and subordinated liabilities, to the extent that they are classified in Tier 1, would also be classified as Tier 2 ancillary own funds.

3.152. Therefore, classification should be tested against the characteristics and features of the Tier 1 item that arises through making the relevant claim. Reference is made to paragraph 3.84 of this paper for those characteristics and features.

Supplementary member calls of mutual and mutual-type undertakings

3.153. Article 96 states that any future claims which mutual or mutual-type associations of ship-owners with variable contributions solely insuring risks listed in classes 6, 12 and 17 in point A of Annex 1 may have against their members by way of a call for supplementary contributions, within the next twelve months, shall be classified in Tier 2.

3.154. Article 96 also states that in accordance with sub-paragraph 2 of Article 94(2), any future claims which mutual or mutual-type associations with variable contributions may have against their members by way of a call for supplementary contributions, within the next twelve months, not falling under point 3 of subparagraph 1 (of Article 96) shall be classified in Tier 2 where they substantially possess the characteristics set out in points (a) and (b) of Article 93(1), taking into consideration the features set out in Article 93(2).

3.155. Supplementary member calls are claims that a mutual or mutual-type undertaking with variable contributions has on its members to provide consideration – usually cash – when it sustains losses. The consideration received directly forms part of the undertaking's capital as it increases the excess of assets over liabilities. That capital is classified as Tier 1.

3.156. In line with CEIOPS view that Tier 1 should consist of capital of the highest quality, CEIOPS recommends that supplementary member calls of mutual or mutual-type associations, within the next twelve months, are classified in Tier 2, provided that:

- the call can be made on demand;
- the call generates Tier 1 own funds;
- the call is clear of encumbrances.

3.157. The call must be clear of encumbrances while it is classified in Tier 2. This means that the mutual or mutual-type undertaking's members cannot set off the call against another claim, whereby the undertaking would effectively forego the own funds to be received.

3.158. In QIS4, 40% of the maximum callable amount specified in the statutes of the mutual or mutual-type undertaking were classified in Tier 2 ancillary own funds, and the rest in Tier 3 ancillary own funds.

3.159. The split approach represented a compromise. CEIOPS, then, as now, considers the split to be arbitrary.

3.160. With the revised criteria for Tier 1 and the proposed limit structure, CEIOPS is of the view that the treatment of supplementary member calls as set forth in para. 3.142 is justified.

3.161. Moreover, by taking this approach, CEIOPS is of the view that it would avoid requiring an overhaul of the financing structure of mutual and mutual-type undertakings, which could result in such undertakings no longer being viable.

b) Tier 3 requirements

3.162. Subject to the proposed limit structure being implemented, and taking into account the supervisory approval of ancillary own funds, CEIOPS is of the view that Tier 3 ancillary own funds do not need to be subject to any specific requirements.

3.1.5 Methods of supervisory approval

3.163. The Level 1 text requires the Commission to adopt implementing measures laying down the methods to be used by supervisory authorities when approving the assessment and classification of own fund items which are not covered by the list referred to in point (a) of Article 97.1.

3.164. Supervisory approval of the assessment and classification requires supervisory judgment; not only because of the need to assess whether the own fund items possess the characteristics and features set forth in the Level 1 text and in implementing measures, but also because own fund items can take many (legal) forms and be subject to national specificities.

3.165. Moreover, the assessment process needs to be flexible enough to allow the supervisory authority to consider market innovations.

3.166. Therefore, CEIOPS recommends that a mechanistic approach should be avoided as far as possible. The approach to supervisory approval should be principle-based.

3.167. While implementing measures may suffice ultimately, CEIOPS recommends allowing room for the criteria below to be elaborated on as part of Level 3 supervisory guidance, should divergent supervisory practices become an issue in practice.

3.168. CEIOPS notes that supervisory approval should be granted before (re)insurance undertakings are allowed to include an own fund item not covered by the list.

3.169. The undertaking is responsible for verifying whether its own fund items comply with the list as well as the required characteristics envisaged in the implementing measures for the classification in different tiers.

3.170. Accordingly, the (re)insurer will assess the appropriate classification of the own fund item for which it seeks supervisory approval and whether the inclusion of this item is compatible with the quantitative limits envisaged by the implementing measures to cover the Solvency Capital Requirement and the Minimum Capital Requirement. The (re)insurer is responsible for providing the related documentation.

3.171. The request for approval should include at least the following details:

- amount to be used;
- legal form of the element to be included;
- counterparty (belonging to the same group or not);
- the capacity of the own funds item to absorb losses either on a going concern basis (Tier 1) or in a winding up (Tier 2 and 3);
- whether the item is fully paid in or called up;
- duration of the item;
- existence of requirements or incentives to redeem the instrument;
- existence of mandatory fixed charges;
- subordination in winding up;
- duration of insurance and reinsurance obligations.

3.172. The supervisory authority can request further information from the undertaking. On the basis of the information available, the supervisory authority grants approval; refuses approval; or grants approval for a different classification than requested.

The approval process: How does the supervisory authority reach its decision?

3.173. CEIOPS recommends a three step process when granting supervisory approval of the own fund item not covered by the list as set forth below.

Step 1. The supervisory authority, taking into account the legal enforceability and the characteristics of the item, assesses to what extent it possesses the characteristics of permanent availability and subordination. In addition, the supervisory authority assesses whether the duration of the item is compatible with the maturity of the undertaking's insurance and reinsurance obligations. For undated items without a call this assessment is unnecessary.

Step 2. The supervisory authority assesses to what extent the item possesses the features of absence of incentive to redeem; mandatory servicing costs and encumbrances.

Step 3. The supervisory authority assesses whether the inclusion of the item is compatible with the quantitative limits envisaged by implementing measures to cover the Solvency Capital Requirement and the Minimum Capital Requirement.

3.174. CEIOPS recommends that (re)insurance undertakings use a similar process when seeking approval, as this would streamline the approval process.

3.175. In this three-step assessment process, the supervisory authority should consider the characteristics and requirements included in the Level 1 text and in the implementing measures.

3.176. In principle, this supervisory approval occurs once and is not repeated. Approval lasts until the legal maturity of the item.

3.177. However, CEIOPS recommends that where the characteristics and features of the item change, following the activation of a contractual trigger or through the restructure of the item, the (re)insurance undertaking should submit a new request. The supervisory authority should carry out a new assessment and grant a new approval.

3.178. The process would be the same as when an item is first submitted to the supervisory authority for assessment and approval.

3.1.6 Cross sector consistency

3.179. CEIOPS recognizes that the absence of cross sector consistency can create opportunities for regulatory arbitrage. CEIOPS also recognizes that Solvency II principles for own funds are not identical to CRD principles for own funds. Also, banks and insurance or reinsurance undertakings can have different own fund structures given the differences in the nature of their businesses and in the contractual duration of their products.

3.180. Areas where the Level 1 text takes a different approach compared to the CRD include the recognition of ancillary own funds, the concept of excess of assets over liabilities, and the "sufficient duration" principle

3.181. These differences will not be unwound in implementing measures and will result in some cross-sector inconsistency.

3.182.At the same time, there are similarities with the banking regime in specific areas. Also, there are areas where cross sector inconsistency cannot be justified, with specific reference to the qualitative criteria needed for classification in different tiers.

3.183.Areas identified where a degree of cross-sectoral consistency could be applied, include:

- certain aspects of the treatment of capital instruments;
- the non-recognition of certain assets in own funds, e.g. goodwill.

3.184.CEIOPS notes that the definition of own funds for banks is currently under international review. Therefore, aligning Solvency II implementing measures with the existing framework for banks does not make sense; and aligning with the evolving banking framework is problematic, if not impossible because of timetable differences. However, CEIOPS is aware of endeavours in the banking arena to improve the quality of own funds and considers this advice should be consistent with that aim.

3.185.For alignment between the future insurance and banking frameworks, consideration could be given to the establishment, within the implementing measures, of a future opportunity for evaluation and review for the purpose of cross-sectoral consistency following implementation of Solvency II.

3.2 CEIOPS' advice

General

3.186.Tier 1 should contain the highest quality own funds which fully absorb losses and enable an undertaking to continue as a going concern.

3.187.The proportion of Tier 1 items in eligible own funds must be significantly higher than one third of the total amount of eligible own funds. This limit is discussed further in paragraphs 3.192 ff.

3.188.Compared to QIS4, the average quality of own funds should be increased by:

- increasing the amount and quality of Tier 1;
- increasing the quality of Tier 2; and
- decreasing the amount, and increasing the quality, of Tier 3.

3.189.CEIOPS acknowledges that there is a role for high quality hybrids in Tier 1, provided that in stressed situations, they can convert or write down to provide higher quality capital in the form of equity. Any inclusion of high quality hybrids should be restricted i.e. they should account for no more than 20% of Tier 1.

3.190.To be classified as Tier 1, capital instruments must be fully paid in.

3.191. For inclusion in own funds, there should be certain minimum qualitative requirements. In particular, Tier 3 basic own funds should contribute towards avoiding insolvency as well as towards avoiding the acceleration towards insolvency.

Proposed limit structure

3.192. CEIOPS recommends that the limit structure is set so as to ensure that:

- in relation to compliance with the Solvency Capital Requirement, the proportion of Tier 1 is greater than the proportion of eligible Tier 2, and that the proportion of eligible Tier 2 is greater than the proportion of eligible Tier 3. Tier 3 may be included (subject to the limits), regardless of whether undertakings have Tier 2 eligible own funds or not;
- in relation to compliance with the Minimum Capital Requirement, the proportion of Tier 1 is greater than the proportion of eligible Tier 2 basic own funds.

3.193. CEIOPS interprets the term eligible own funds as own funds that count toward covering the SCR and the MCR, subject to the framework of the limits structure.

3.194. Tier 3 basic own funds are eligible to cover the Solvency Capital Requirement, but not eligible to cover the Minimum Capital Requirement. Ancillary own funds are eligible to cover the Solvency Capital Requirement, but not eligible to cover the Minimum Capital Requirement.

3.195. CEIOPS recommends that, as far as the compliance with the Solvency Capital Requirement is concerned:

- the proportion of Tier 1 items in eligible own funds is at least 50% of the total amount of eligible own funds (a minority of CEIOPS members have expressed a preference for at least 60%) and

- the proportion of Tier 3 items in eligible own funds is set at a maximum of 15% of the total amount of eligible own funds. The appropriate percentage would be linked to the characteristics required for elements to be included in Tier 3, taking into account the requirements proposed for the characteristics required for Tier 3 in this paper (see 3.64 and 3.137 to 3.145)

3.196. At this juncture, CEIOPS believes that, as far as the compliance with the Minimum Capital Requirement is concerned:

- the proportion of Tier 1 items in eligible own funds is at least 80% of the total amount of eligible own funds.

Minimum characteristics for own funds

3.197. Tier 3 basic own funds should demonstrate features to ensure that subordination is effective and not just a nominal requirement.

3.198. Tier 3 basic own funds should not be freely redeemable, or coupons on Tier 3 basic own funds be freely payable, when an undertaking's solvency position is deteriorating, or is foreseen to deteriorate.

3.199. To be eligible own funds all cash flows on own fund items (i.e. both coupon and principal payments) should be subject to supervisory approval once the Solvency Capital Requirement is breached.

3.200. No own fund items should be allowed to cause, or accelerate, an undertaking to go into insolvency.

3.201. Any redemption, conversion or exchange of capital instruments, including any premiums paid in on those instruments, should be subject to prior supervisory approval.

Sufficient duration

3.202. Capital instruments should be included in own funds on the basis of their issue date.

3.203. The duration of the capital instrument is defined as the first contractual possibility of repayment. When determining duration, the time horizon must be the expected duration, or anticipated duration over the next twelve months.

3.204. Capital instruments should have benchmark minimum maturities to ensure that capital is of a sufficient duration. With this in mind CEIOPS recommends that the minimum maturity at issue date should be:

- 10 years for Tier 1,
- 5 years for Tier 2,
- 3 years for Tier 3,

3.205. Issuers should still take into account the maturity profile of their liabilities in order to have in place adequate capital management plans, and to ensure consistency with the Level 1 text.

3.206. The average duration of own fund items should not be significantly lower than the average duration of an undertaking's liabilities. The undertaking must assess the sufficient duration of own fund items on a reporting date basis as part of its risk management. This assessment would be part of the ORSA and the supervisory review process, and would be disclosed to the public.

Basic own funds

a) Tier 1 requirements

Capital instruments

3.207. List:

- **a.** Paid in ordinary share capital
- **b.** Paid in equivalent of ordinary share capital of mutual and mutual-type undertakings.
- **c.** Other paid in capital instruments, including preference shares that absorb losses first or rank *pari passu*, in going concern, with capital instruments that absorb losses first.
  - a. Instruments that automatically convert to ordinary share capital, or to the equivalent of ordinary share capital of mutual and mutual-type undertakings, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its Solvency Capital Requirement.
  - b. Instruments subject to write down as long as losses persist, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its Solvency Capital Requirement.

3.208. Tier 1 own funds should display the following key features:

i. **Subordination:** the item must be the most deeply subordinated in a winding-up.

ii. **Loss absorbency:** the item must be fully paid in, must be the first instrument to absorb losses or rank *pari passu* with an instrument that substantially absorbs first losses, and must not hinder recapitalization.

iii. **Sufficient duration:** the item should not have a legal maturity of less than 10 years at issue date. The item must be contractually locked-in on a breach of the Solvency Capital Requirement where redemption is only permitted in exceptional circumstances, if the item is replaced by an own fund item of equivalent or higher quality and subject to the consent of the supervisory authority.

iv. **Free from requirements or incentives to redeem:** there must be no incentives to redeem the item. The item must only be redeemable at the option of the undertaking (i.e. not at the option of the holder) and any redemption should be subject to the approval of the supervisory authority.

v. **Free from mandatory fixed charges:** at all times coupons/dividends must be able to be cancelled and must at a minimum be cancelled on a breach of the SCR after which they can only be paid in exceptional circumstances and subject to the consent of the supervisory authority. Undertakings should have full discretion over the amount of payment; coupons/dividends must not be at a fixed rate and there should be no preference as to income or return of capital.

vi. **Absence of encumbrances:** the instrument must be free from encumbrances and therefore should not be connected with any other transaction which, when considered with the own fund item, could undermine the characteristics of that item. Examples of potential encumbrances include, but are not limited to, rights of set off, restrictions, charges or guarantees. Where an investor subscribes for capital in an undertaking and at the same time that undertaking has provided financing to the investor, only the net financing provided by the investor is considered as eligible own funds.

3.209. In relation to the requirement that the own fund item does not hinder recapitalization, this should be taken to mean that the investors are the first to be called upon to recapitalize the undertaking, if Tier 1 capital instruments are ordinary share capital or the equivalent capital of mutual or mutual-type undertakings.

3.210. In relation to hybrid Tier 1 capital instruments, the requirement that the own fund item does not hinder recapitalization should be taken to mean that the instrument absorb losses in going concern through appropriate mechanisms so that potential future outflows to the holders of the instrument are reduced.

3.211. In both cases, the principle underlying the requirement that the own fund item does not hinder recapitalisation is that Tier 1 capital instruments must absorb losses first.

<u>Other own fund items</u>

3.212. List:

a. Reserves, to the extent that they are available to absorb losses at any time arising from any segment of liabilities or from any risks, including:

i. retained earnings

ii. share premium account

iii. surplus funds falling under Article 91(2)

iv. revaluation reserves

v. other reserves

b. Paid in subordinated mutual member accounts

Less:

c. Own shares, or units of equivalent capital of mutual and mutual-type undertakings, held by the undertaking. Adopting an economic approach and applying the principle of substance over form, where there is evidence of a group of connected transactions whose economic effect is the same as the holding of 'own shares', the assets that those transactions generate for the undertaking shall be deducted from its own funds, to the extent necessary to guarantee that own funds reliably represent the net financial position of its shareholders, further to other allowed items.

Excluded from Tier 1 excess of assets over liabilities are:

a. Reserves, the use of which is restricted, should only be eligible for inclusion in own funds in relation to the risks they cover. The amount in excess of that covering the related risks should therefore be excluded from own funds (CEIOPS preferred option) or as explained in paragraph 3.101 the excess item should be included under tier 3.

b. The difference between the value of technical provisions calculated in accordance with Articles 75 to 86, i.e. on a going concern basis, and the amounts that the original undertaking shall have to pay to its policyholders to honour their rights according to the contracts in force in the case of winding up with no transfer of portfolios. Where such a difference exists, it should be classified as Tier 3. This calculation shall allow for the amounts that policyholders are legally or contractually obliged to pay to the undertaking in a situation of winding up. ("winding-up gap")

c. Deferred tax assets, which should be excluded from own funds or be classified in Tier 3 . See paragraphs 3.222 to 3.223 below.

d. Intangible assets not valued at zero and not subject to a capital charge should be excluded from own funds or included as Tier 3 and subject to an intangible asets risk module. See paragraph 3.224 below.

e. Expected future profits See paragraphs 3.216 to 3.221 below

3.213. The European Commission has indicated to CEIOPS members that its interpretation of the Level 1 text is that once assets and liabilities are valued under article 75, the net arithmetical result constitutes own funds. The own funds articles merely require classification into tiers and do not permit any item to be excluded or the amount at which it is recognised adjusted on the grounds of lack of quality eg availability and/or loss absorbency.

3.214. This interpretation was not the understanding of CEIOPS' Members at the time the Level 1 text was developed. The advice set out in the consultation paper was drawn up on the basis that potential own funds items need to be assessed firstly to establish whether they have the necessary quality to be eligible as own funds and secondly allocated to tiers having regard to their particular characteristics. There is a clear distinction between the valuation of particular items on an economic basis and the extent to which they can properly contribute to capital available to meet the risks arising in a (re)insurance undertaking. CEIOPS remains of the view that the approach adopted in the consultation paper is necessary to deliver a prudentially sound regime for own funds under Solvency II. CEIOPS also notes the importance of cross-sectoral consistency and considers there are no sound reasons for there to be an inconsistent approach. This is particularly the case given international consensus confirmed by the G20 on the importance of the quality of capital in the financial services sector.

3.215. In the advice CEIOPS has indicated where it considers items should be restricted in their inclusion in own funds in accordance with the above. However recognising the position of the Commission CEIOPS has also indicated a treatment which may satisfy the alternative interpretation put forward by the Commission. In most cases this involves classifying items in tier 3 and/or introducing an appropriate risk charge.

3.216. '***Expected future profits'*** are defined as the actual value of any type of profit included, either explicit or implicitly, in the future inflows considered in the calculation of the best estimate. Implicit profits shall be assessed using appropriate actuarial methods.

3.217. According to the provisions set out in articles 75 to 85, *the 'expected future profits'*, as defined above, contribute to the excess of assets over liabilities, and therefore they are an element of the basic own funds. The Level 1 text requires testing this item, as any other, against the loss-absorbency criteria set out in articles 93 and 94.

3.218. Solvency II aims to guarantee a 99.5 per cent confidence level, protecting policyholders' rights where there is a transfer of the business of the undertaking in difficulties, even in circumstances where such a transfer is problematic. Where this is the case to the extent that the transfer is not possible '*expected future profits*' represents an item with no capacity for loss absorption.

3.219. Having in mind this legal and technical rationale, CEIOPS has concluded that qualifying *'expected future profits'* as tier 3, is the more appropriate and legally necessary solution according article 94(3), since this item does not possess the characteristics necessary to be considered as tier 1 or 2. However insurance contracts which are subject to consideration under the winding up gap referred to in paragraph 3.212 may also give rise to expected future profits. Where this is the case there should be no double counting of the amount excluded from Tier 1 and classified as Tier 3.

3.220. In terms of the impact of this advice based on the Level 1 text, CEIOPS notes that Solvency I only allows future profits for life insurance business under restrictive requirements. These profits currently represent a very limited proportion of own funds.

3.221. Conversely, Solvency II expands the allowance of '*expected future profits*' to any type of insurance business (therefore, life, non-life and health).

3.222. Any treatment of **deferred tax assets** in own funds would necessarily depend on the general approach to deferred tax. On the basis that deferred tax will be calculated on the entire solvency balance sheet, and considering that deferred tax assets are assets of a contingent nature representing losses that can be offset against future taxable profits, CEIOPS considers that deferred tax assets could be treated in one of two ways.

- The assets do not absorb losses in a going concern or in a winding up and should be excluded entirely from own funds(apart from the amount expected to be used in the next twelve months or unless they can be transferred to another entity – in accordance with the relevant tax legislation): As the realisation of deferred tax assets is dependent on future taxable income, they are of limited value for the undertaking in terms of their ability to absorb losses in times of stress/deficits or in a winding-up.
  - The assets may have limited loss absorbing capacity: The realisation of deferred tax assets depends on making the relevant future taxable income and have a zero value on winding up unless they can be transferred to another entity. Therefore, apart from the amount expected to be used in the next twelve months or unless they can be transferred to another entity - in according with the relevant tax legislation - they should be included in Tier 3.

3.223.Underlying both options is the consideration that, as the solvency position of an undertaking deteriorates, the accounting value of deferred tax assets rises, while their economic value falls. Recognising such assets in full appears contradictory to the aim of the solvency balance sheet. Care should be taken to avoid counting the benefit of deductible tax losses twice in the assessment of the solvency position of undertakings.

3.224.To the extent that **intangible assets**, other than goodwill, have been purchased, and can be readily resold, they should be treated as any other asset, to the extent that they are subject to a capital charge. Intangible assets not valued at zero and not subject to a capital charge should be excluded from own funds.

3.225.If this is not deemed possible in line with the Commission's interpretation, intangible assets should be regarded as Tier 3. However in this case, in order to ensure that the risks attaching to intangible assets are addressed CEIOPS recommends the introduction of an intangible asset risk module in the SCR standard formula. A detailed explanation underpinning this proposal including advice is set out in Annex B.

c) Tier 2 requirements

<u>Capital instruments</u>

3.226.List:

- **a.** Called up ordinary share capital
- **b.** Other called up capital instruments that absorb losses first or rank *pari passu*, in going concern, with capital instruments that absorb losses first.
- **c.** Other capital instruments, including preference shares, that do not have the conversion features required for Tier 1 but that display the features below.
- **d.** Other capital instruments, including preference shares, not subject to write down as long as losses persist, but that display the features below.

3.227.Tier 2 basic own funds should display the following key features:

i. **Subordination:** the item must be effectively subordinated in a winding-up.

ii. **Loss absorbency:** the item does not need to be fully paid in, but can simply be called up, and must absorb losses to some degree. The undertaking must be able to defer coupon payments once the SCR has been breached.

iii. **Sufficient duration:** the item should not have a legal maturity of less than 5 years at issue date. The item must be contractually locked-in on a breach of the Solvency Capital Requirement where redemption is only permitted if the item is replaced by an own fund item of equivalent or higher quality and subject to the consent of the supervisory authority.

iv. **Free from requirements or incentives to redeem:** there may be moderate incentives to redeem the item. The item must only be redeemable at the option of the undertaking (i.e. not at the option of the holder) and any redemption should be subject to the approval of the supervisory authority.

v. **Free from mandatory fixed charges:** coupons/dividends must at a minimum be deferred for an indefinite term on a breach of the Solvency Capital Requirement after which they can only be paid subject to the consent of the supervisory authority.

vi. **Absence of encumbrances:** the instrument must be free from encumbrances and therefore should not be connected with any other transaction which, when considered with the own fund item, could undermine the characteristics of that item. Examples of potential encumbrances include, but are not limited to, rights of set off, restrictions, charges or guarantees. Where an investor subscribes for capital in an undertaking and at the same time that undertaking has provided financing to the investor, only the net financing provided by the investor is considered as eligible own funds.

<u>Other own fund items</u>

3.228.List: No items.

C) Tier 3 requirements

<u>Capital instruments</u>

3.229.List:

a. Other capital instruments, including preference shares, that do not display the features required for Tier 1 or Tier 2.

3.230.Tier 3 basic own funds should possess at least some of the characteristics and features required for Tier 1 and Tier 2 eligibility, but to a lesser degree.

3.231.Tier 3 basic own funds should be prevented from having characteristics and features that undermine effective subordination.

- Tier 3 basic own funds should be free from encumbrances.
- There should be no redemption of Tier 3 basic own funds, or coupon payments, on a breach of the SCR (i.e. during the ladder of supervisory intervention), unless the supervisory authority determines that redemption is necessary to facilitate a recapitalisation.
- Tier 3 basic own funds should have a minimum maturity (e.g. 3 years).

<u>Other own fund items</u>

3.232.List:

Included in Tier 3 reserves are:

a. The difference between the value of technical provisions calculated in accordance with Articles 74 to 85, that is, on a going concern basis, and the amounts that the original undertaking shall have to pay to its policyholders to honour their rights in the case of winding up with no transfer of portfolios.
b. Deferred tax assets, (if not excluded from own funds) e classified in Tier 3
c. Expected future profits.

Ancillary own funds

a) Tier 2 requirements

3.233.List:

a. Ordinary share capital callable on demand
b. Equivalent of ordinary share capital, callable on demand, of mutual and mutual-type undertakings
c. Supplementary member calls of mutual or mutual-type undertakings, within the next twelve months, that can be made on demand, where the call generates Tier 1 own funds and is clear of encumbrances
d. Letters of credit and guarantees which are held in trust for the benefit of insurance creditors by an independent trustee and provided by credit institutions authorised in accordance with Directive 2006/48/EC
e. Other capital instruments, callable on demand, that absorb losses first or rank *pari passu*, in going concern, with capital instruments that absorb losses first
    - Instruments that automatically convert to ordinary share capital, or to the equivalent of ordinary share capital of mutual and mutual-type undertakings, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its Solvency Capital

Requirement

- Instruments subject to write down as long as losses persist, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its Solvency Capital Requirement

3.234. Ancillary own fund items classified in Tier 2 should be callable own funds of the highest quality and demonstrably absorb unexpected losses to enable an undertaking to continue as a going concern.

3.235. Unless otherwise stated in the Level 1 text, for classification in Tier 2, ancillary own fund items should represent own fund items which, if called up and paid in, would be classified in Tier 1.

3.236. Classification should be tested against the characteristics and features of the Tier 1 item that arises through making the relevant claim.

b) Tier 3 requirements

3.237. List:

a. Callable preference shares classified in Tier 2 or Tier 3
b. Other callable capital instruments classified in Tier 2 or Tier 3

Methods of supervisory approval

3.238. Supervisory approval of the assessment and classification requires supervisory judgment.

3.239. The assessment process should be flexible enough to allow the supervisory authority to consider market innovations.

3.240. CEIOPS recommends that a mechanistic approach be avoided to the extent possible. Supervisory approval should take a principle-based approach.

3.241. CEIOPS recommends allowing room for the criteria below to be elaborated on as part of Level 3 supervisory guidance, should divergent supervisory practices become an issue in practice.

3.242. The undertaking is responsible for verifying whether its own fund items comply with the list and the required characteristics envisaged in the implementing measures for the classification in different tiers.

3.243. The (re)insurer assesses the appropriate classification of the own fund item for which it seeks supervisory approval and whether the inclusion of this item is compatible with the quantitative limits envisaged by the implementing measures to cover the Solvency Capital Requirement and the Minimum Capital Requirement. The (re)insurer is responsible for providing the related documentation.

3.244. The request for approval should include at least the following details:

- amount to be used;
- legal form of the element to be included;
- counterparty (belonging to the same group or not);
- the capacity of the own funds item to absorb losses either on a going concern basis (Tier 1) or in a winding up (Tier 2 and 3);
- if the item is fully paid or called up;
- duration of the item;
- existence of requirements or incentives to redeem the instrument;
- existence of mandatory fixed charges;
- subordination in winding up;
- duration of insurance and reinsurance obligations.

3.245. The supervisory authority can always request further information from the undertaking. On the basis of the information available, the supervisory authority grants approval, refuses approval, or grants approval for a different classification than requested.

3.246. CEIOPS recommends a three step process when granting supervisory approval of the own fund item not covered by the list as set forth below.

Step 1. The supervisory authority, taking into account the legal enforceability and the characteristics of the item, assesses to what extent it possesses the characteristics of permanent availability and subordination. In addition, the supervisory authority assesses whether the duration of the item is compatible with the maturity of undertaking's insurance and reinsurance obligations. For undated items without a call this assessment is unnecessary.

Step 2. The supervisory authority assesses to what extent the item possesses the features of absence of incentive to redeem, mandatory servicing costs, and encumbrances.

Step 3. The supervisory authority assesses whether the inclusion of the item is compatible with the quantitative limits envisaged by implementing measures to cover Solvency Capital Requirement and the Minimum Capital Requirement.

3.247. CEIOPS recommends that (re)insurance undertakings use a similar process when seeking approval, as this would streamline the approval process.

3.248. In this three-step assessment process, the supervisory authority should consider the characteristics and requirements included in the Level 1 text and in the implementing measures.

3.249.The approval is given for the item until its legal maturity.

3.250.However, CEIOPS recommends that where the characteristics and features of the item alter through a contractual trigger, or through the restructuring of an item, the (re)insurance undertaking submits a new request, and the supervisory authority carries out a new assessment and grants a new approval.

3.251.The procedures to be followed would be the same as when an item is first submitted to the supervisory authority for assessment and approval.

Cross sector consistency

3.252.For alignment between the future insurance and banking frameworks, consideration could be given to providing the possibility in the implementing measures for evaluation and review following implementation of Solvency II.

ANNEX A More detailed explanation of the winding-up gap.

Introduction

A.1. The so-called '*winding up gap'* item arises from the purpose of Article 93 of the Level 1 text, whose content makes evident the aim to protect policyholders' rights both in a going concern and winding up. Furthermore, in any of these cases Solvency II aims to provide protection both where it is possible to transfer the portfolios of any undertaking in difficulties, and where such a transfer is not possible.

A.2. The '*winding up gap'* item relates to the case where the undertaking enters into a winding up situation, having regard to the manner in which insolvency law and winding up proceedings operate in different Member States.

Legal background

A.3. Article 276, *Applicable law,* of the Level 1 text (one of the 'recasting' articles) sets out:

> *2. The law of the home Member State shall determine at least the following: […]*
>
> *(c) the conditions under which set-off may be invoked;*
>
> *(d) the effects of the winding-up proceedings on current contracts to which the insurance undertaking is party;*

A.4. At the same time, recital 85 reflects:

> *(85) All the conditions for the opening, conduct and closure of winding-up proceedings should be governed by the law of the home Member State.*

A.5. Therefore, it is evident that the Level 1 text empowers Members States to address the treatment or termination of contracts in the case of winding up and that the termination values should be determined according to the law of the home Member State. The treatment arising for these purposes would differ from an application of the valuation criteria of articles 75 to 84.

Practical application

A.6. The aforementioned conclusions are also consistent with the protection of policyholders' rights in the winding up of an undertaking in difficulties, or otherwise.

A.7. When an undertaking enters into a winding up situation, one possible measure to protect policyholders may be to give them the right to an early termination of their contracts. This right is even more significant where the value of the assets is lower than the value of liabilities.

A.8. Consider a logistics firm with a large number of vehicles insured on a group-fleet policy. The entity cannot be obliged to continue covering its fleet of vehicles with the undertaking in difficulties, since future claims might not be fully settled by the undertaking, endangering the position of the logistics firm.

A.9. Another example may be an industrial plant company which has borrowed money. If the undertaking insuring its risks experiences stress, the rating/credit quality of the industrial plant may be revised, as the renewal conditions of its loans may be restricted. Therefore the industrial plant company should be allowed to look for a better/sound provider of insurance protection.

A.10. A third example may be a policyholder, either institutional or retail, with a long-term retirement insurance contract (employees' benefits or individual pension scheme). These policyholders may not wish to remain for decades with an undertaking in run-off (even more when they perceive any serious risk that such an undertaking might not be able to meet its commitments),

A.11. Once an undertaking enters into winding up proceedings, depending on contracts and jurisdictions, there could be numerous cases where the protection of policyholders' rights may lead to termination or commutation of the existing contracts.

A.12. This has been explained for the case where there is no transfer of portfolio, but it also applies where such transfers occur. The Level 1 text allows Member States to provide policyholders a separation right (under the rationale that they cannot be compelled to insure their risks with another undertaking different to that originally selected).

A.13. In conclusion, the above situation is one that should be considered to protect policyholders' rights, both due to the explicit reference in the Level 1 text and also to the existence of real situations of practical application.

Termination value

A.14. In addition to the legal basis to determine termination values according to the law of the home Member State, there are sound economic reasons to consider that these values may/should be different (higher) than the valuations obtained according to articles 75 to 84.

A.15. An appropriate protection of policyholders of an undertaking in a winding up situation, may define termination value as a '*replacement value*', that is, the price that the policyholder would have to pay to obtain the same coverage for the period to run on the original insurance policy.

A.16. This approach is easily demonstrated with a simple example of an annual non-life insurance contract, where the undertaking encounters difficulties at a certain point. If the policyholder receives the best estimate determined according to article 75 to 84, such amount may well be insufficient to buy/restore the protection with an equivalent insurer.

A.17. Another example is the case of life insurance contracts, where policyholders may have options for early termination of the contract, but these may allow for a reduction in the amount receivable (penalties, etc.). In case of winding up, it is clear that an application of such penalties would be unfair from the point of view of the consumer.

A.18. The conclusion is that in some contracts and jurisdictions there is a difference between the valuation of technical provisions according to articles 75 to 84 and the termination values due to policyholders in the case of winding up. This difference is described as the '*winding up gap*'.

ANNEX B Intangible assets risk module

Introduction

B.1. The following advice has been developed as a consequence of the Commission's interpretation that any asset recognised with a value for solvency purposes contributes to the excess of assets over liabilities. See paragraphs 3.92 to 3.94

B.2. In the case of intangible assets Article 74 of the Level 1 text allows them to be taken into account at their fair value under certain requirements (Paragraphs B.7 ff. below set out the content of CEIOPS' advice in this respect).[12]

B.3. While under this approach, basic own funds shall allow for (increase with) the value of intangible assets, this does not prejudge the classification of the corresponding own funds into tiers, according to the criteria set out in Articles 93 and 94 of the Level 1 text.

B.4. CEIOPS notes that the risks inherent in intangible assets have not been considered in the standard calculation of the SCR. Therefore, in order to maintain CEIOPS' advice consistent with the content of Article 101(3), CEIOPS has developed a module for the calculation of an adequate capital charge for intangible assets.

Article 101(3)

3. The Solvency Capital Requirement shall be calibrated so as to ensure that all quantifiable risks to which an insurance or reinsurance undertaking is exposed are taken into account....

B.5. CEIOPS considers the proposal contained in this advice compatible (and necessary) with the Level 1 text in light of Article 101(4):

4. The Solvency Capital Requirement shall cover at least *the following risks:*

(a) non-life underwriting risk;

(b) life underwriting risk;

(c) health underwriting risk;

(d) market risk;

(e) credit risk;

[12] See CEIOPS-DOC-31/09 mentioned previously.

(f) operational risk.

B.6. The insertion during the negotiations of the Level 1 text of the phrase '*at least*' was precisely to allow for cases as that now arising with intangible assets, given the interpretation recently provided by the Commission.

Valuation for solvency purposes and other relevant background

B.7. CEIOPS' advice on valuation of assets and liabilities, other than technical provisions, CEIOPS-DOC-31/09 contains the following explanatory text regarding the valuation of intangible assets.

B.8. [To ensure readers have the final version of the CEIOPS-DOC-31/09 advice, please refer to http://www.ceiops.eu/index.php?option=content&task=view&id=583.]

Valuation for solvency purposes:

In contrast to goodwill, some intangible assets may be acquired individually or generated internally.

Apart from intangibles acquired in a business combination, cf. below, IAS 38 requires an entity to recognise an intangible asset if, and only if, specified criteria are met for identification and recognition. Some of those assets can only, according to IFRS, be recognised based on their cost price because there do not exist an active market where they are traded.

Among the intangibles that can be recognised according to IFRS outside a business combination there are some intangibles that are separable and for which there is a history or evidence of exchange transactions for same or similar assets indicating it is saleable in the market place. CEIOPS considers in such cases, a fair value measurement under IAS 38 to be compatible with Article 74 of the Level 1 text. As a result, IAS 38 is considered a good proxy if and only if intangible assets can be fair valued according to this IAS.

If a fair value measurement under circumstances explained above is not possible, intangible assets should be valued at nil for solvency purposes.

Other intangibles are like goodwill solely to be recognised when they are acquired in a business combination. Identifiable assets that are not allowed to be recognised in the normal course of business should, according to IFRS, be recognised when acquired in a business combination. For example customer lists, brand names and other intangibles are not allowed to be recognised unless they are acquired in a business combination (IAS 38). Such *intangibles that are based on IAS 38 only recognised in a business combination should be valued at nil for solvency purposes. The same arguments as for goodwill equally apply to intangibles.*

B.9. CEIOPS-DOC-31/09summarizes its advice on the valuation of intangible assets for solvency purposes, in the two following statements:

The IFRS on Intangible assets is considered to be a good proxy if and only if the intangible assets can be recognised and measured at fair value as per the requirements set out in that standard. The intangibles must be separable and there should be an evidence of exchange transactions for same or similar assets, indicating it is saleable in the market place.

If a fair value measurement is not possible or when intangible assets are only recognised as a result of a business combination according to the applicable international standard, intangible assets shall be valued at nil for solvency purposes.

B.10. Furthermore, *IAS 38 Intangible assets*, as in January 2009, when defining the so-called '*revaluation model*', in respect of the fair value of intangible assets[13] applicable for Solvency II purposes, contains the following wording that facilitates a better understanding of the risks inherent to these kind of assets:

'… *For the purpose of revaluations under this Standard, fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value…*

An active market is a market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.'

B.11. For the sake of completeness, it is useful to recall that paragraph 64 of IAS38 also states:

Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be

[13] See IAS 38, paragraph 64. See also the Technical summary IASC IAS 38 *Intangible Assets* as issued at 1 January 2009, http://www.iasb.org/NR/rdonlyres/8A3C6720-AABE-4BE2-B776-0BBE51961AA0/0/IAS38.pdf

distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Risk inherent to intangible assets from a solvency perspective

B.12. Given this background, intangible assets are exposed to a twofold set of risks:

a) Market risks, as for other balance sheet items, derived from the decrease of prices in the active market, and also from unexpected lack of liquidity of the relevant active market, that may result in an additional impact on prices, even impeding any transaction,

b) Internal risks, inherent to the specific nature of these elements (see IAS 38, paragraphs 103-106, where there is an explicit recognition of these risks)[14]:

- Risks linked to either failures or unfavourable deviations in the process of finalization of the intangible asset, or any other features in such a manner that future benefits are no longer expected from the intangible asset or its amount is reduced. This may occur in case of, e.g. failure in the methodology or pattern of development applied, or lack of resources to continue the development due undertaking's financial difficulties.

- Risks linked to the commercialization of the intangible asset, e.g. where the undertaking experiences difficulties and the deterioration of its public image endangers the commercial possibilities of the intangible asset.

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[14] 103 The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

Review of amortisation period and amortisation method

104 The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in accordance with IAS 8.

105 During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

106 Over time, the pattern of future economic benefits expected to flow to an entity from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Proposed capital charge.

B.13. Given this list of risks, it is evident that the risks considered in the different market risk sub-modules do not capture all the risks that an intangible asset is exposed to. Hence, the insertion of intangible assets in any of these sub-modules would underestimate the relevant capital charge.

B.14. Furthermore, the inclusion of intangible assets within the market risk module would allow for diversification benefits with the market risk submodules and with the other four top modules of the Basic SCR (counterparty default, life, non-life and health). The nature of the risks means that this approach could not be justified as sound.

B.15. Therefore, CEIOPS proposes an intangible asset risk module as one of the top elements of the Basic SCR, in addition to the five modules used in QIS4: market, counterparty default, non-life, life and health risks. The capital charge derived from this module should be summed, with no diversification benefit, to the SCR resulting from the correlation matrix involving the five aforementioned modules, since it is considered that any difficulty of the undertaking, independently of its source, will likely trigger the internal risks identified in respect of intangible assets (and in a number of stressed scenarios, furthermore the specific market risks).

Therefore

Basic_SCR = SCR_market_default_life_health_non-life +

SCR_intangible_assets.

B.16. The capital charge could be calculated, in principle, as follows:

*SCR_intangible_assets = factor_IA * fair value intangible assets,*

where

factor_IA = 100 per cent

B.17. The calibration of *factor_IA* is based on the assumption that the calculation of the SCR of an intangible assets should consider its fair value both under stressed circumstances of the active market where the intangible asset is traded, and also under a situation where the own undertaking is in difficulties and its public image and financial capabilities are deteriorating. According to this approach, CEIOPS considers that intangible assets are linked in an important degree to the external image of the undertaking (and additionally the specific negative development of markets).

B.18. However, the excess of assets over liabilities corresponding to intangible assets would be considered as a tier 3 element if this module is being applied. Should the tier 3 limit be triggered then a double counting effect may come into play. The capital charge should address this double counting.

B.19. Therefore, the formula reflected in paragraph 15 should be refined as follows:

*SCR_intangible_assets = factor_IA * fair value intangible assets –*

Tier3_double_counting_prevention

where *Tier3_double_counting_prevention* is the amount of intangible assets not considered as own funds due to the triggering of the limit of tier 3. The effect of triggering the tier 3 limit should be allocated among the different eligible items of own funds included in this tier, according to a reasonable method (e.g. proportionally, unless there is evidence to suggest that other approaches produce a better outcome from an economic view).

CEIOPS' Advice

B.20. Where basic own funds allow for (increase with) the value of intangible assets, (and independently of the classification into tiers of the basic own funds corresponding to such assets) CEIOPS recommends that the risks inherent in intangible assets should be considered in the standard calculation of the SCR.

B.21. For this purpose, CEIOPS considers that all risks intangible assets are exposed to should be taken into account, including not only market risks, but also internal risks, inherent to the specific nature of these elements (e.g. linked to either failures or unfavourable deviations in the process of finalization of the intangible asset, or any other features in such a manner that future benefits are no longer expected from the intangible asset or its amount is reduced; risks linked to the commercialization of the intangible asset, triggered by a deterioration of the public image of the undertaking).

B.22. CEIOPS considers that the risks taken into account in the different market risk sub-modules do not capture all the risks that an intangible asset is exposed to. Hence, the insertion of intangible assets in any of these sub-modules would underestimate the relevant capital charge.

B.23. Furthermore, the inclusion of intangible assets within the market risk module would allow for diversification benefits with the market risk sub-modules and with the other four top modules of the Basic SCR (counterparty default, life, non-life and health). The nature of the risks means that this approach could not be justified as sound.

B.24. The capital requirement for intangible assets shall be calculated as follows:

*SCR_intangible_assets = factor_IA * fair value intangible assets –*

Tier3_double_counting_prevention

where

factor_IA = 100 per cent, and

Tier3_double_counting_prevention is the amount of intangible assets not considered as own funds due the trigger of the limit of tier 3. The effect of triggering the tier 3 limit should be allocated among the different eligible items of own funds included in this tier, according to a reasonable method.

B.25. The module should be one of the top elements of the Basic SCR, and therefore added to the five modules specified in the Level 1 text: market risk, counterparty default risk, non-life underwriting risk, life underwriting risk and health underwriting risk. The capital charge derived from this module shall be summed, with no diversification benefit, to the SCR resulting from the correlation matrix involving the five aforementioned modules

Therefore

Basic_SCR = SCR_market_default_life_health_non-life +

SCR_intangible_assets.

B.26. CEIOPS considers the proposal contained in this advice compatible (and necessary) with the Level 1 text in the light of Article 103 and in particular paragraph 4 of that article.

ANNEX C Impact Assessment on limits for own funds

In its Call for Advice of 1 April 2009, the Commission has asked CEIOPS to contribute to the Commission's impact assessment of the Level 2 implementing measures.[15] To this end, a list of issues has been set up by the Commission and CEIOPS, identifying the Level 2 implementing measures that should be accompanied by an impact assessment. The objectives of the issues have been selected among the list of objectives used by the Commission in its Level 1 impact assessment.[16] On 12 June 2009, the Commission has issued an updated list of policy issues and options, to which reference is being made.[17] This impact assessment covers issue 3 of the list of policy issues and options. A summary table accompanying the impact assessment is published in a separate excel document.

The impact assessment takes into account the results produced through the QIS4 excercise.

1. Description of the policy issue

C.1. The issue deals with the limits which should apply to the different tiers of own funds in respect of coverage of the SCR and MCR.

C.2. The Level 1 text requires quantitative limits to be set for the components of own funds that are eligible to cover the Solvency Capital Requirement and the Minimum Capital Requirement in implementing measures.

2. Detailed description of policy options and assessment of the relative impacts on the different affected parties

Policy Options:

C.3. Five options have been identified as set out in the accompanying spreadsheets. These vary according to the minimum amount of Tier 1 required to cover the SCR, the maximum amount of Tier 3 permitted to cover the SCR and the minimum amount of Tier 1 to cover the MCR.

C.4. Options 2 to 4 consider different combinations of levels for Tier 1 and Tier 3. Option 1 based on Level minimum requirements provides a baseline and link to QIS 4.

[15] http://www.ceiops.eu/media/files/requestsforadvice/EC-april-09-CfA/EC-call-for-advice-Solvency-II-Level-2.pdf.
[16] http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf.
[17] http://www.ceiops.eu/media/files/requestsforadvice/EC-June-09-CfA/Updated-List-of-policy-issues-and-options-for-IA.pdf.

Option 1:
SCR: min 1/3 T1 (=> max 2/3 T2) and max 1/3 T3
MCR: min 50% T1

Option 2:
SCR: min 50% T1 (=> max 50% T2) and max 25% T3
MCR: min 50% T1

Option 3:
SCR: min 50% T1 (=> max 50% T2) and max 15% T3
MCR: min 80 % T1

Option 4:
SCR: min 50% T1 (=> max 50% T2) and max 15% T3
MCR: min 100 % T1

Option 5:
SCR: min 60% T1 (=> max 40% T2) and max 15% T3
MCR: min 100 % T1

Impact on industry, policyholders and beneficiaries and supervisory authorities

<u>Costs and Benefits</u>

- **Industry**

C.5. Some members of the industry in their feedback argued that limits should be as set out in the Level 1 text.

C.6. However this should be balanced with CEIOPS' advice proposing the inclusion of high quality hybrids in Tier 1. While QIS4 suggested a very high percentage of Tier 1 it is not clear to what extent losses have eroded the position since. QIS5 will therefore provide industry with a better basis of comparison.

C.7. Options 3 to 5 are likely to have the greater impact in terms of capital needed, since they envisage more Tier 1 and less tier 3 that options 1 and 2. However as explained above this needs to be viewed in the light of QIS4 data.

C.8. CEIOPS is of the view that the effect of increasing and/or maintaining the quality of eligible own funds within each undertaking will help the industry to withstand any future systemic shocks.

- **Policyholders and beneficiaries**

C.9. Policyholders and beneficiaries can be affected in two different ways. Under options 2 to 5 the (re)insurance undertaking may need to hold a greater amount of capital as compared with option 1. This could result in a higher cost-of-capital rate, and consequently higher premiums to pay if premiums were to fund any rise in the cost of capital.

C.10. However, policyholders will benefit from the increased capital available to absorb unexpected losses.

- **Supervisory Authorities**

C.11. A lower level of tier 1 could lead to more undertakings encountering difficulties leading to more cases of supervisory intervention.

Relevant objectives

D.1. The relevant operational objectives are

- introduce risk-sensitive harmonised solvency standards,
- introduce proportionate requirements for small undertakings and
- promote compatibility of prudential supervision of insurance and banking
- promote compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA.

Comparison between the different options based on the efficiency effectiveness in reaching the relevant operational objectives

C.12. CEIOPS took account of the need for a significant amount of the SCR to be covered by Tier 1 reflecting the increasing market and supervisory consensus that undertakings need to demonstrate the ability to withstand losses in order to retain the confidence of the market and their policyholders. This is in line with the developments ongoing in the revision of the banking regulation. This also features in the international debates held on the need for higher quality and quantity of capital (IAIS, Financial Stability Board, G20 etc)

C.13. Further discussion of CEIOPS' approach to formulating its advice is set out in paragraphs 3.47 to 3.61.

The examples shown in paragraphs 3.59 to 3.61 explain why CEIOPS considers that a minimum of 80% of the MCR should be covered by Tier 1 rather than 100% as envisaged under options 4 and 5. This is to ensure effective operation of the ladder of supervisory intervention. Hence, this option would best achieve the objective of introducing risk sensitive harmonised solvency standards.

C.14. As explained in the advice, CEIOPS recommends an SCR coverage based on Option 3. A minority of members would favour an increase of the Tier 1 percentage in this option to 60%. CEIOPS considers that a credible level of Tier 1 is required in respect of the SCR and this should be at least 50%. Some members consider the minimum should be 60%.

D.2. In conclusion, taking into account potential costs and benefits for policy-holders and beneficiaries, insurance and reinsurance undertakings and supervisory authorities, the effectiveness and efficiency level to meet the relevant objectives, CEIOPS recommends option 3 in its advice.