EIOPA Solvency II technical specifications: MCR, Own Funds and Groups

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The release of updated technical specifications by EIOPA brings many of the requirements for future quantitative assessments in line with the draft Solvency II Level 2 Implementing Measures

INTRODUCTION

On 18 October 2012, the European Insurance and Occupational Pensions Authority (EIOPA) released Part 1 of the technical specifications for the Solvency II valuation and Solvency Capital Requirements calculations. This document, and the accompanying annexes, updates the approach and calculations that firms should follow under future quantitative assessments, and specifically the upcoming Long Term Guarantee Assessment (LTGA).

EIOPA highlights that these technical specifications make use of ad hoc simplifications for the purposes of impact assessments and, as such, should not be considered as a complete implementation of the Solvency II framework.

Part 1 of the technical specifications sets out the approach that firms should follow in respect of:

- the valuation of assets and calculation of the best estimate liabilities and risk margin;
- the structure and calculation of the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR);
- the treatment of participations;
- the classification and eligibility of own funds; and
- the treatment of groups.

To assist you in digesting the updated technical specifications, Milliman has prepared a series of summary papers, including analysis of what any changes to the requirements may mean for firms.

This summary paper covers the Minimum Capital Requirement (MCR), Own Funds and Groups. Further papers cover the changes in relation to the valuation of assets and liabilities and the Solvency Capital Requirement (SCR).

GENERAL OVERVIEW OF THE TECHNICAL SPECIFICATIONS

While the technical specifications include many changes since the version used for QIS5, many of these changes have been introduced to bring the technical specifications into line with the draft Level 2 Implementing Measures (DIM) produced by the European Commission in October 2011. Although this DIM text has not been officially published, it has been made widely available as a basis for Solvency II implementation, and, as such, few of the changes should come as a surprise to firms.

The introduction to the current technical specifications highlights that a number of sections have been deliberately not included. EIOPA does not consider that these provide key information for the purposes of the quantitative tests that may be launched in the coming months. These include relevant parts of the SCR calculation such as sections on:

- internal models;
- undertaking specific parameters; and
- certain group-specific components including the combination method, the treatment of Participations, Ring Fenced funds and internal model for group calculation.

EIOPA has commented that the first part of the technical specifications does not cover areas which relate to the Long Term Guarantee (LTG) package (including the matching adjustment and counter-cyclical premium) which are still the focus of trilogue discussions. As such, details of the discount rate to be used for calculations of the technical provisions are due to be covered in a second part of the technical specifications to be released at a later date.

MCR

Under the updated technical specifications, the MCR remains based on a linear formula with a floor of 25% and a cap of 45% SCR.

While the overall formula remains unchanged, the technical specifications make a number of changes to the weighting factors to be used for non-life technical provisions and the written premiums to be used to calculate the non-life MCR component for future quantitative assessments, both relative to the QIS specifications and the DIM text.

We note that the values of the α and β factors to be used in the calculation of the linear component MCR_{NL} for non-life (re)insurance obligations for quantitative assessments have decreased for all lines of business relative to those set out under QIS5 (with the exception of the factors to be applied for "Assistance and its proportional reinsurance"). As such, for most firms, the non-life MCR component calculated with these factors may be expected to be lower than that calculated under QIS5.

OWN FUNDS

The guidance relating to own funds for the purposes of future quantitative assessments has changed significantly from both QIS5 and from the DIM text. Notably, the criteria by which own funds are split into tiers has changed and the tiering structure itself has also been amended. In addition, no transitional provisions or grandfathering arrangements have been included in this part of the technical specifications. Detailed below are the changes made in relation to the DIM text.

Tier 1 own funds

The technical specifications specify that for quantitative assessments, Tier 1 basic own funds should be split between restricted and unrestricted items.

Items classified as unrestricted Tier 1 basic own funds in the technical specifications for the purpose of future quantitative assessments are listed as:

- paid-in ordinary share capital and the related share premium account;
- paid-in initial funds, members' contributions or the equivalent basic own-fund item for mutual and mutual-type undertakings;
- a reconciliation reserve (defined in a consistent manner to the DIM text); and
- surplus funds that meet the criteria of permanent availability[1] and subordination[2], and hence are not considered (re)insurance liabilities, under Article 91(2) of the Solvency II Directive.

Restricted Tier 1 basic own funds are defined as own fund items which do not fulfil the criteria for classification as unrestricted Tier 1 basic own funds but which:

- rank after the claims of all policyholders, beneficiaries and non-subordinated creditors;
- are fully paid-up;
- have no specified maturity;
- are only repayable or redeemable at the option of the firm, and repayment or redemption is subject to prior review by the supervisor;
- allow the firm to cancel or defer payment of interest or dividends in relation to the item; and
- provide for the loss-absorption capacity of the item, while enabling the firm to continue its business.

Under the technical specifications, restricted Tier 1 own funds must constitute less than 20% of total Tier 1 own funds used to cover the SCR and the MCR. Restricted Tier 1 own funds in excess of the 20% limit are available as Tier 2 basic own funds.

In addition, the following guidance has been added:

- a notional MCR applies in respect of each of the life and non-life activities of a composite undertaking and the basic own funds covering each of these must be identified; and
- a firm may include in a lower tier of own funds any item that cannot be included in a higher tier due to the eligibility requirements.

We note that while the expected profit included in future premium (EPIFP) no longer features as a specific item in the technical specifications (as it did under QIS5), this forms part of the reconciliation reserve and, as such, will be classified as unrestricted Tier 1 own funds under future quantitative assessments.

[1] Permanent availability - 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.

[2] Subordination - 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 policy holders and beneficiaries of insurance and reinsurance contracts, have been met.

We note that a number of items which were classified as Tier 1 basic own funds in the DIM text are not included in the list of unrestricted Tier 1 own fund items. These include:

- *paid-in subordinated mutual member accounts;*
- *paid-in preference shares and related share premium account; and*
- *paid-in subordinated liabilities valued in accordance with Article 75 of Solvency II Directive.*

These would be treated as restricted Tier 1 own fund items for the purposes of future quantitative assessments. As such, these items are restricted to making up less than 20% of total Tier 1 own funds eligible to cover the SCR and MCR.

While the same eligibility restrictions exist in Article 72 of DIM, this text did not explicitly create the concept of restricted own funds.

The guidance in relation to the classification of the unrestricted Tier 1 items has been updated in the technical specifications, as set out below.

Paid-in ordinary share capital

A new section has been added to the technical specifications giving further guidance on how paid-in ordinary share capital should be identified and classified for the purposes of a quantitative assessment. Under this, paid-in ordinary share capital can be identified by the following properties:

- shares are issued directly by the firm with the prior approval of its shareholders or, where permitted under national legislation, the firm's Board; and
- the shares entitle their owners to a claim on the residual assets of the firm in the event that it is wound up, the share being proportionate to the amount of such instruments issued and not fixed or subject to a cap.

The specifications now also state that where a firm describes more than one class of ordinary share capital:

- the criteria for classification as ordinary share capital are applied to each class separately;
- to be classified as ordinary share capital, a class of ordinary share must meet all relevant criteria and in particular the criteria contained in the technical specifications concerning full discretion over distributions;
- differences between classes which provide for one class to rank ahead of another or which create any preference as to distributions have to be identified;
- only the class which ranks after all other claims and has no preferential rights is classified as ordinary share capital; and
- classes ranking ahead of the most subordinated class, or which have other preferential features which do not satisfy the criteria for ordinary share capital, are classified as preference shares provided they meet all relevant criteria for this item.

Reconciliation reserve

The text concerning the reconciliation reserve has been extended, bringing the definition into line with DIM, and including new guidance on the adjustments that should be made for the purpose of future quantitative assessments:

- the amount of own shares held by the firm, which are removed from the reconciliation reserve, should include both direct and indirect holdings;
- dividends or distributions become foreseeable at the latest when they are declared or approved by the firm's Board, regardless of any requirement for formal approval at the AGM; and
- where a participating undertaking holds a participation in another undertaking which has a foreseeable dividend, the participating undertaking makes no reduction to its reconciliation reserve for that foreseeable dividend.

Classification of unrestricted Tier 1 basic own funds

Further guidance has been included in the technical specifications to help firms with the classification of unrestricted Tier 1 basic own funds for quantitative assessments. This includes clarifying that:

- the criterion that own funds items cannot include features which may cause or accelerate the process of insolvency within the firm is fulfilled if:
  - the holder of the instrument cannot petition for the insolvency of the issuer in the event of distributions not being made;
  - the item is not treated as a liability when testing for insolvency under applicable national legislation; and

- the holder of the instrument does not have the ability to cause full or partial payment of the amount invested, or to demand compensation payments as a result of a distribution being cancelled.

- a basic own fund item is immediately available to absorb losses only if it is paid in and there are no conditions of contingencies in respect of its ability to absorb losses;
- the need to have full flexibility over distributions from own funds (to be classified as unrestricted Tier 1) requires that the terms of the contract governing the own funds item cannot require a distribution to be made in the event of a distribution being made on any other instrument issued by the firm. For this purpose, the technical specifications explicitly define distributable items as retained earnings and distributable reserves (the amount of which must be determined on the basis of individual and not consolidated accounts for future quantitative assessments); and
- the treatment of encumbrances (which basic own funds must be free from).

While the section of the technical specifications addressing the classification of Tier 1 basic own funds has been significantly expanded, this does not contain any new classification criteria since QIS5, but, rather, provides additional guidance on how these requirements should be interpreted.

While requirements in relation to unrestricted Tier 1 basic own funds have been brought in line with the DIM text, we note that the provision set out in DIM permitting the supervisor, in certain circumstances, to waive the suspension of repayments, redemptions and distributions of own fund items where the undertaking cannot meet its SCR, has not been included in the technical specifications.

Tier 2 and Tier 3 own funds

Rather than using the specific list of Tier 2 basic own fund items and accompanying criteria for classification as set out in the DIM text and the technical specification for QIS5, the technical specifications now use a principle-based approach. This defines Tier 2 own funds as basic own fund items that do not fulfil the criteria for unrestricted or restricted Tier 1 for the purpose of quantitative assessments.

Tier 3 basic own funds are limited to net deferred tax assets in the updated technical specifications.

As Tier 2 and Tier 3 ancillary own funds require prior supervisory approval these will not form part of any future quantitative assessment, and hence are not included in the technical specifications.

We note that grandfathering arrangements were of particular concern for many firms following the QIS5 exercise, particularly in relation to hybrid instruments. While these technical specifications do not contain details of any transitional or grandfathering arrangements for own funds, it is unclear if these are not to be tested under future quantitative assessments or if these will be included in Part 2 of the technical specifications.

GROUPS

The technical specifications for groups have been updated, bringing this section into line with the DIM text. As noted in the overview, this is an area where EIOPA has deliberately left out a number of items from the technical specifications for the purposes of quantitative assessments. These include the combination method, the treatment of Participations, Ring Fenced Funds and the use of internal models for group calculation. As such, this section of the specifications is greatly simplified compared to both the DIM text and the technical specifications used for QIS5.

Under the technical specifications, groups will only need to calculate their group SCR and own funds using one method for quantitative assessments (rather than testing two approaches under QIS5). The default approach set out in the technical specifications is the Accounting Consolidation-based method, consistent with the DIM text, although the alternative Deduction and Aggregation method may be used by firms where:

- there is insufficient amount and quality of information available;
- a subsidiary is not covered by the group internal model; or
- the use of the default method for the solo firm in a group would be overly burdensome and the nature, scale and complexity of the risks of the group are such that the use of alternative method does not materially affect the results of the group solvency calculation.

Group SCR

Where groups are using the accounting consolidation method, the technical specifications require firms to calculate the consolidated SCR for quantitative assessments considering full data from:

- all insurance and reinsurance subsidiaries;
- third country subsidiaries; and
- any insurance holding companies and ancillary services companies that are subsidiaries of the group (proportional data should be used where the responsibility is limited to the share of the capital the group holds).

Where the group has holdings in related insurance or reinsurance firms (including those in third countries) and reinsurance holding companies which are not subsidiaries of the group, these should be included using the adjusted equity method.

The technical specifications state that for the purposes of quantitative assessments, participations in the following types of related undertakings should be excluded from the calculation of group solvency:

- credit institutions;
- investment firms and financial institutions;
- institutions for occupational retirement provision, within the meaning of Directive 2003/41/EC; and
- non-regulated undertakings carrying out financial activities.

Additional guidance is provided in respect of the calculation of the group SCR, including details on:

- the loss absorbing capacity of technical provisions – including details of a formula for application;
- adjustments for the loss absorbing capacity of deferred tax liabilities and assets (broadly consistent with the treatment under QIS5); and
- the minimum consolidated group SCR – equal to the sum of the subsidiary MCRs and the proportionate share of the MCR of related insurance undertakings and insurance holding companies (again broadly consistent with QIS5).

Group own funds

The approach for assessing eligible own funds at a group level has been updated in the technical specifications. For future quantitative assessments, firms should perform the following default method:

1. calculate group own funds on consolidated data, net of any intra-group transactions;

2. classify group own funds into tiers;

3. reduce group own funds for any own funds not available at group-level; and

4. apply the same tiering limits as at the solo level for covering the group SCR and MCR.

Consistent with the DIM text, the list of own funds that should be considered as effectively not available to cover the SCR of a subsidiary included in the group SCR for quantitative assessments has been expanded to specifically include:

- ancillary own funds;
- preference shares;
- subordinated mutual members account;
- subordinated liabilities; and
- net deferred tax assets.

Equivalence

Where group structures include insurance companies outside of the EEA, or where groups are headquartered in third countries, the technical specifications reiterate that the relevant equivalence assessments will not be available for the impact assessment and so sets out the treatments that should be applied, updating those set out for QIS5.

For the purpose of quantitative assessments, where EEA groups with third country subsidiaries use the deduction and aggregation method, firms can calculate the MCR, SCR and own funds of the subsidiary using local regulations where the third country:

- has been assessed for equivalence by EIOPA;
- is on the list for transitional equivalence; or
- is subject to an on-going project on mutual understanding or cooperation.

For groups headquartered outside of the EEA with an EEA subgroup, the group calculations should continue to be conducted using Solvency II rules at the level of the EEA subgroup. However, the technical specifications make an exception for Swiss-based groups, where the group calculations should be performed using the Swiss Solvency Test for quantitative assessments.

Consistent with QIS5, where third country reinsurers are used by firms, the risk mitigation provided should be treated as if it were provided by EEA reinsurers for the purpose of quantitative assessments.

SUMMARY

The updated technical specifications published by EIOPA set out the approach that should be used by firms when performing calculations for future quantitative assessments of the Solvency II requirements. These make a number of changes to the previous specifications used by firms during the QIS5 exercise.

A second part of the technical specifications is due to be released in due course and is expected to provide further details relating to the valuation of liabilities and, in particular, the discount rate to be used.

While the requirements in relation to the MCR are largely unchanged from those under QIS5, the text relating to own funds has changed significantly from both QIS5 and from the DIM text. Notably, more details have been included on the criteria by which own funds are split into tiers, and the tiering structure itself has also been amended. While, no transitional provisions or grandfathering arrangements have been included in this part of the technical specifications, it remains unclear whether these areas will not be tested under future quantitative assessments or whether details on this will be included in Part 2.

The technical specifications for groups have been updated, bringing this section into line with the DIM text. However, the specifications are greatly simplified compared to both the DIM text and the technical specifications used for QIS5. As noted in the overview, this is an area where EIOPA has deliberately not included a number of items for the purposes of quantitative assessments. These areas include the combination method, the treatment of Participations, Ring Fenced funds and internal model for group calculation.

As EIOPA has highlighted, these technical specifications make use of ad hoc simplifications for the purposes of impact assessments and, as such, should not be considered as a complete implementation of the Solvency II framework.

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