QIS5 Results: Own Funds

March 2011

EIOPA has published the results of the fifth Quantitative Impact Study conducted across reinsurance and insurance undertakings throughout Europe in 2010. While the report demonstrates increased participation in the latest study it also highlights significant work which needs to be done to reduce complexity in the guidance and to ensure consistency across territories.

INTRODUCTION

On 14 March 2011 EIOPA issued its report on the fifth Quantitative Impact Study (QIS5) for Solvency II. The study was conducted during the second half of 2010 in order to assess the impact and practicability of the potential quantitative requirements under the new insurance directive Solvency II.

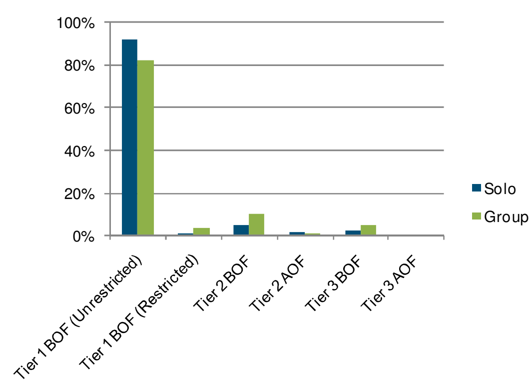
The report confirms that most companies understood the high level principles of the exercise's requirements regarding own funds. However there were a number of technical areas which firms commonly struggled with or misinterpreted. To address this, further work will be required to bring clarity and consistency to the assessment of own funds under the final Solvency II standards.

To assist you in digesting these reports, Milliman has produced the following short summary highlighting the key results and findings surrounding own funds. This is part of a series of Milliman summaries covering the key areas of QIS5.

OWN FUNDS - OVERVIEW

For QIS5, participants were required to classify their own funds (broadly, the difference between assets and liabilities) into three capital tiers defined by several loss absorbency criteria. In aggregate, individual companies categorised over 90% (80% for groups) as unrestricted Tier 1 capital, which is fully available to cover the SCR and MCR.

The following chart sets out the Europe-wide breakdown of own funds for both solo and group undertakings between basic own funds (BOF) and off-balance sheet capital, known as ancillary own funds (AOF).



Basic own funds for individual companies were 27% higher than the equivalent position under the current reporting regime; this increased to 38% for groups. EIOPA cited changes in the valuation approach as the main driver of this difference. The most material component of this was the significant reduction observed in technical provisions under Solvency II.

EIOPA has highlighted a number of key issues requiring further guidance and development, which are discussed further below.

Many companies have struggled to assess the quantity and quality of own funds available. Whatever the reason for this, companies should make a realistic assessment of their available own funds rather than try to ignore this issue.

Many companies may find themselves needing to raise the quantity and quality of available capital in order to ensure sufficient coverage of their regulatory capital requirements.

The need to raise further capital is one better identified and managed sooner rather than later, particularly given potential timescales and market demands from other insurers attempting the same tasks.

TRANSITIONAL PROVISIONS

The central scenario under QIS5 assessed own funds on a "without transitional measures" basis, i.e. as if full compliance was required on day one of the new regime. QIS5 also tested a proposed set of transitional arrangements. In its report, EIOPA reiterated the importance of having provisions in place to ensure a smooth transition to the new regime in order to avoid market disruption. The difference in the level of own funds under the two scenarios was intended to quantify this need for transitional arrangements.

However, inconsistent or loose interpretation of the technical specification by many companies limited the usefulness of a comparison at the aggregate level. Several national supervisors reported that companies commonly included hybrid and/or subordinated debt instruments within their own funds under the central QIS5 scenario, although they believed these would not qualify in the absence of transitional provisions. EIOPA also noted that not all participants included an assessment of own funds under the transitional scenario.

Despite these issues, the total level of subordinated liabilities, preference shares and other forms of paid-in capital reported by solo companies on average made up 5.2% of available own funds. This would indicate that hybrid capital and subordinated debt make up a material contribution to the capital base of European (re)insurers and suggests there is a clear need for appropriate transitional arrangements. EIOPA reports that further work is taking place to arrive at a system where companies can move to accurately reflect the loss absorbency of their total capital base in a timely fashion.

The draft Omnibus II directive, issued in January 2011, allows for a potential transitional arrangement around the classification of own funds into tiers.

Given the significant proportion of capital that is currently held in instruments that may not be classified as own funds under the new regime, the European Commission may wish to take advantage of such arrangements to ensure that companies can manage the transition of their capital base to Solvency II without significant market disruption.

CAPITAL TIERS

Solvency II will require companies and groups to split their basic own funds between three main tiers by looking at specified characteristics including the level of subordination, loss absorbency, tenor and redemption clauses. Each tier is then subject to individual limits for the purposes of meeting the SCR and MCR.

Under QIS5, companies were asked to assess the eligibility of Tier 2 and 3 capital in one of two ways:

- a "top-down" approach in which Tier 2 capital is utilised first or
- a "bottom-up" approach in which Tier 3 capital is assigned first.

This approach was adopted to simplify the operation for QIS5. In practice under Solvency II undertakings would make their own choice as to the balance between Tier 2 and Tier 3.

Analysis of the capital limits and tiering allocations was complicated by inconsistency in reporting between the "with" and "without" transitional arrangements scenarios. Despite this, EIOPA was able to draw some broad conclusions:

- the choice between the top-down and bottom-up approaches did not prove to be significant for either individual companies or groups; and
- some of the limits, notably 20% on restricted Tier 1 capital and 15% on Tier 3 capital, were observed to bite for a significant number of companies.

RING-FENCED FUNDS

The QIS5 Technical Specifications contained information designed to help undertakings identify when they have ring-fenced funds – that is, where own funds items have a reduced capacity to fully absorb losses on a going concern basis. In order to gain insight into the types of ring-fenced arrangements, undertakings were asked to describe the arrangements giving rise to ring-fenced funds and the nature of the restrictions which apply.

Countries reporting ring-fenced funds did so on the basis that transfers out of the fund were restricted (or not allowed at all). In terms of the calculations carried out by those undertakings identifying ring-fenced funds, undertakings appear to have had difficulty recording the calculations consistently through the relevant parts of the spreadsheet.

Ring-fenced funds, including with-profits funds, were reported by 80 participants providing €17.3bn of assets.

Once a ring-fenced fund has been identified it does not necessarily mean that there will be an adjustment restricting the own funds within the ring-fenced fund. Only if there are own funds in excess of the notional SCR will an adjustment be necessary. Five countries account for €7.0bn in terms of adjustment to own funds.

A majority of countries reported that there were no ring-fenced arrangements within their territory. In some cases where undertakings concluded that there was no ring-fencing, this did not align with the views of the local supervisory authority or other parts of the industry. The above results suggest that participants and supervisors would benefit from greater clarity about the characteristics of ring-fenced funds.

EXPECTED PROFITS INCLUDED IN FUTURE PREMIUMS (EPIFP)

The inclusion of the EPIFP was a new test introduced in the QIS5 exercise, the results of which will be used to inform the ongoing debate between the industry and supervisors regarding the treatment of future profits on the Solvency II balance sheet. It was defined for QIS5 as the difference between the technical provisions assuming all policies were made immediately paid up and the equivalent result under central best estimate assumptions. It was assumed to meet the criteria for inclusion as unrestricted Tier 1 capital.

Participants identified numerous issues with the EPIFP as it was defined for the purposes of the QIS5 exercise, including:

- insufficient data upon which to base the calculation of the EPIFP;
- the artificial nature of making certain products paid-up when in reality they cease to have any value when premium payments are cancelled;
- concern over the time-consuming nature of the calculation approach and whether separate identification of the EPIFP provides a significant benefit;
- the potentially significant amount that the EPIFP will represent on a company’s balance sheet ; and
- a challenge to the concept of the EPIFP itself.

Throughout the development of the own funds requirements, several sections of the European insurance industry, including key industry bodies, have voiced concerns at the proposed identification of future profits separately on the Solvency II balance sheet.

We note that, even prior to the formal commencement of QIS5, the inclusion of the EPIFP, which represents the latest attempt to capture future profits, has been challenged against the principle of market consistency upon which Solvency II is based and at a product level for providing unintuitive or artificial results.

The rather negative response from QIS5 participants in submitting results under this test reflects these concerns.

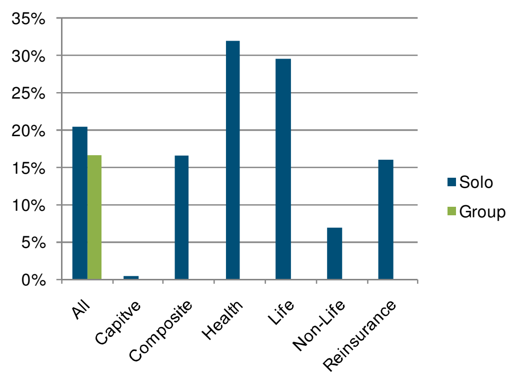
Unsurprisingly, these issues strongly influenced the level of engagement with the EPIFP calculation, with many companies electing not to carry out the calculation.

For those that did provide a value of the EPIFP, it was observed that EPIFP accounted for an average of 20% of Tier 1 own funds (and in some cases over 50%). In Ireland the EPIFP represented almost 30% of Tier 1 capital.

EPIFP was more material for life and health insurers than non-life participants due to the typically longer-term nature of such products.

Results should be treated carefully, as they differ greatly between undertakings and countries.

The following graph summarises the EPIFP as a proportion of total Tier 1 capital, split by category of undertaking.



SUMMARY

In general, the increased participation for QIS5 relative to QIS4 demonstrates that the industry is engaging with EIOPA on the development of Solvency II. This should help create a final Solvency II solution that is better aligned with a wider range of companies' needs and expectations.

The report highlights a number of issues surrounding the assessment of own funds and the treatment of certain key components, such as hybrid and subordinated capital and future profits. These are areas where EIOPA is expected to issue further guidance.

QIS5 is expected to be the last in the series of impact studies and, as such, any further improvements to the Solvency II regime will be through ad hoc work and tests leading to the finalisation of the delegated acts (formerly known as the Level 2 Implementing Measures) later this year and the subsequent consultation on the Level 3 guidance.

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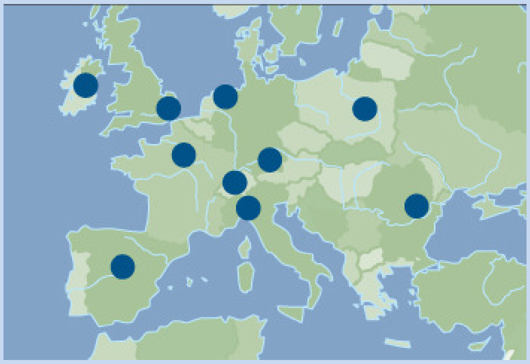

CONTACT

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