

## Solvency II – Own Funds – Tier 1 and Tier 2 requirements and grandfathering

11/06/2010

### Introduction

Under Solvency II, capital is referred to as “own funds”. CEIOPS last year issued its formal advice on classification and eligibility of own funds and on 5 July the Commission issued technical specifications for Quantitative Impact Study 5 (“**QIS 5**”). The minimum level and composition of a (re)insurer’s own funds is determined by reference to its Solvency Capital Requirement (“**SCR**”) and its Minimum Capital Requirement (“**MCR**”). The MCR is first calculated in accordance with a standard formula and then adjusted if necessary to fall within a corridor of 25-45% of the SCR. The SCR can be calculated in accordance with a standard formula or, with prior regulatory approval, in accordance with an internal model.

Own funds are divided vertically between “basic own funds” and “ancillary own funds” and horizontally between Tiers 1, 2 and 3 (however, there are no Tier 1 ancillary own funds). Basic own funds are defined as assets minus liabilities (this is subject to certain adjustments: subordinated liabilities are added back; treasury shares are deducted; and the recognition of reserves is limited based on their availability for loss absorbency). Ancillary own funds are capital instruments that can be called up to absorb losses, specifically including unpaid share capital, letters of credit, guarantees and any other legally binding commitment received by the (re)insurer. These can only be recognised with regulatory approval, and their valuation is also subject to regulatory approval.

(Re)insurers must hold basic own funds in Tiers 1 and 2 to back their MCR. CEIOPS’s final advice (reflected in the QIS 5 technical specifications) was that Tier 1 comprise at least 80% of the MCR.

(Re)insurers can use both basic and ancillary own funds in all tiers to back their SCR. Importantly, however, CEIOPS’s final advice (also reflected in the QIS 5 technical specifications) was that Tier 1 comprise at least half of the SCR, with Tier 3 comprising no more than 15% of the SCR.

### **Tier 1 in overview**

Tier 1 is the dominant form of capital under Solvency II. Under the Directive, instruments can be included in Tier 1 if they substantially possess the characteristics of:

**permanent availability** (i.e., the instrument is available, or callable on demand, to fully absorb losses on both a going concern basis and in the event of winding-up); and

**subordination** (i.e., in the event of winding-up, the total amount of the item is available to absorb losses and repayment is subordinate to all insurance and reinsurance liabilities).

CEIOPS took a more restrictive position than this in its final advice, effectively suggesting that Tier 1 instruments should rank alongside ordinary share capital both in a winding-up situation (i.e., Tier 1 instruments must be “most deeply subordinated”) and whilst the firm remains a going concern (i.e., Tier 1 instruments must be the first, or equal first, instrument to absorb losses). Also, CEIOPS advised that coupons on Tier 1 instruments should not be set (e.g., at a percentage level), but should be discretionary. These criteria strongly favoured ordinary share capital to the exclusion of other instruments. Notwithstanding this, CEIOPS acknowledged that high quality hybrids could fall within Tier 1. CEIOPS advised that such hybrids should not account for more than 20% of Tier 1.

CEIOPS also advised that mandatorily converting preference shares could fall within Tier 1, but also that no preference as to income or return of capital be permitted in relation to coupons and

that Tier 1 instruments should be “most deeply subordinated” – effectively meaning that they should rank *pari passu* with ordinary share capital on a winding-up.

The QIS 5 technical specifications allow preference shares as a form of “other paid in capital instrument” and the criteria for Tier 1 instruments are somewhat more accommodating than the CEIOPS advice (see below).

### ***Specific requirements for Tier 1***

The Directive allows for capital instruments to be specified which are deemed to fall within given tiers. CEIOPS proposed that paid in ordinary share capital (and the equivalent for mutuals) automatically qualify under Tier 1. Under the QIS 5 technical specifications, preference shares, subordinated debt and subordinated members accounts (described as “other capital paid in instruments”) can be treated as Tier 1 up to a limit of 20% of total Tier 1 own funds. QIS 5 sets out the following criteria for Tier 1 instruments in the draft technical specifications:

- the rights of holders of such instruments are “the most deeply subordinated” or, in the case of “other paid in capital instruments”, senior only to the most deeply subordinated item in the event of the (re)insurer's winding-up;
- the instruments will not cause or accelerate the insolvency of the (re)insurance undertaking. This means that the holder of the instrument must not be in a position to petition for the insolvency of the (re)insurer; and the instrument must not be taken into account for the purposes of determining whether the institution is insolvent (either because it is treated as shareholders' equity or it is not treated as a liability in determining balance sheet insolvency – i.e. where liabilities exceed assets);
- the instruments are fully paid in and are immediately available to absorb losses;
- the instruments absorb losses at least when the (re)insurer breaches its SCR and must not hinder recapitalisation (meaning that they are structured to absorb losses on a going concern basis, such that future outflows to the holders of such instruments are reduced in the event that recapitalisation becomes necessary);
- the instruments must be of sufficient duration, which in the case of Tier 1 means at least 10 years from the issue date to the first contractual opportunity for repayment unless there is a contractual obligation to replace the instrument with an instrument of the same or higher quality capital. (CEIOPS had previously suggested that the duration of Tier 1 instruments should be based on the firm's longest dated insurance liability. The effect would have been that, for those (re)insurers, only undated instruments would satisfy this duration requirement. CEIOPS abandoned this position in its final advice, thereby allowing dated instruments in Tier 1. Nevertheless, CEIOPS cautioned (re)insurers to take account of the maturity profile of their liabilities in managing their capital. In particular, CEIOPS advised that the average duration of a (re)insurer's own funds should not be significantly lower than the average duration of its liabilities);
- early redemption, conversion, cancellation, etc. is only at the option of the (re)insurer and is subject to regulatory approval;
- there must be no incentive for the (re)insurer to redeem the instruments (such as step-ups associated with a call option);
- the instrument must provide for the suspension of its repayment or redemption if the (re)insurer breaches its SCR or where the SCR would be breached as a result of the payment or redemption (such cancellation only being overridden, with the regulator's

approval, if the instrument is exchanged for or converted into another own fund item of equivalent or higher quality and the MCR is complied with);

- the (re)insurer must have full discretion over payment of coupon/dividend or other similar repayments. For ordinary share capital and equivalent items for mutuals, the level of distribution is not in any way tied or linked to the amount paid in on issue and is not subject to a cap; there is no preference as to distribution of income or capital;
- where a (re)insurer exercises its discretion or is required to cancel a coupon/dividend payment, there must be no requirement or entitlement to settle that payment at a future date. Alternative coupon satisfaction mechanisms may be permitted under the terms of the instrument only in the case of “other paid in capital instruments” where they provide for coupons/dividends to be settled through the issue of ordinary shares (unissued ordinary shares must already have been approved or authorised under national law and the (re)insurer’s constitution at the time of the issue of the instruments);
- there must not be any encumbrances or related transactions which undermine the characteristics of the instruments (e.g., set-off rights, charges, guarantees, circular transactions); and
- in respect of “other paid in capital instruments”:
  - the instrument must provide for the cancellation of coupons/dividends upon a breach of the SCR or if paying a coupon or dividend would cause a breach of the SCR (such cancellation only being overridden, with the regulator’s approval, if paying the coupon/dividend does not further weaken the solvency position of the (re)insurer and the MCR is complied with); and
  - the instrument must possess one of two principal loss absorbency mechanisms for which the trigger event is a significant breach of the SCR. The first is that the instrument automatically converts into either an ordinary share or the initial fund at the trigger event. The second is that, at the trigger event, the principal amount of the instrument is written down *pari passu* with retained earnings, by the amount of the breach of the SCR. The instrument can only be written back up again from future profits, also on a *pari passu* basis, once the undertaking complies with the SCR.

### **Tier 2 requirements**

Certain of the requirements for Tier 2 instruments in the QIS 5 technical specifications are less onerous:

- the subordination need only be to policyholders and other unsubordinated creditors;
- the minimum duration is five years (as opposed to ten) and moderate incentives to redeem or repay the instruments (e.g. step-ups, linked to a call option, not exceeding either 100 basis points or 50% of the initial credit spread) are permitted provided that they do not apply before five years from the issue date;
- coupons/dividend payments must be generally deferrable by the (re)insurer but they need only be deferred (as opposed to cancelled) if the SCR is breached (or would be breached as a result of the payment);
- Tier 2 instruments are not required to include the Tier 1 loss absorbency mechanisms referred to above on a significant breach of SCR.

## **Grandfathering**

No provision is made in the Solvency II Directive for grandfathering of own funds and CEIOPS had left it to the Commission to determine whether it wished to introduce grandfathering.

The Commission accepts that grandfathering transitional provisions are necessary to ensure a smooth transition to Solvency II. The grandfathering provisions contained in the QIS 5 technical specifications have been aimed at making grandfathering practicable.

The introduction of grandfathering in principle is a welcome move from the Commission. A number of our clients have recently been looking at the requirements for instruments to qualify as capital under the Solvency II regime.

However, QIS 5 does not currently state if these transitional provisions will apply to pre-Solvency II instruments on a permanent basis, or merely for a temporary period. In addition, these are current proposals only and are not indicative of the final transitional provisions.

A summary of the grandfathering provisions is set out below. Note this is a summary only and we would advise that you check with your usual Linklaters team whether any components of your capital instruments comply with the current grandfathering proposals.

<b>Tier 1</b>	<b>Tier 2</b>
Rank after policyholder and beneficiaries claims and non-subordinated creditors	Rank after policyholder and beneficiaries claims and non-subordinated creditors
Not cause or accelerate insolvency	
Fully paid and immediately available to absorb losses	Fully paid and immediately available to absorb losses
The instrument is undated	The term is not less than five years
Repayable/redeemable at the option of the (re)insurer subject to the approval of the supervisory authority	Repayable/redeemable at the option of the (re)insurer subject to review from the supervisory authority
Incentives are moderate, step ups must not apply for ten years and not exceed 100 bps or 50% of the initial credit spread	Incentives are moderate, step ups must not apply for five years and not exceed 100 bps or 50% of the initial credit spread
Must be able to cancel or defer coupon/dividends in times of stress	
Free from encumbrances	Free from encumbrances

We would broadly expect innovative Tier 1 and Tier 2 instruments complying with the relevant current UK GENPRU rules to meet the QIS 5 requirements for grandfathering. However, the position regarding Tier 2 instruments is obscured by certain disparities between the GENPRU rules and the QIS 5 requirements, as outlined below:

*“The item is undated or has an original maturity of at least 5 years. The maturity date is deemed to be the first opportunity to repay or redeem the basic own-funds item unless there is a contractual obligation to replace the item with an item of the same or higher quality capital.”*

GENPRU 2.2.173R provides that Tier 2 instruments may be redeemed at the option of the Issuer prior to the fifth anniversary of the issue date upon the occurrence of a change in law or regulation (in accordance with GENPRU 2.2.71R to GENPRU 2.2.73G). There is no requirement to issue replacement instruments.

QIS 5 provides no guidance on the acceptability or otherwise of such early calls. One might anticipate however that such calls may, when the final rules are settled, be accepted if Solvency II were to follow the approach of the proposed CRD terms dealing with hybrid capital instruments issued by banks (Article 63(a)(2) of which expressly contemplates early calls for tax and regulatory triggers) and the FSA's proposed rules for implementing the CRD as set out in CP09/29.

*"The item is only repayable or redeemable at the option of the insurance or reinsurance undertaking, subject to review from the supervisory authority."*

GENPRU 2.2.159R(5) provides that Tier 2 instruments may become due and payable prior to the fifth anniversary of the issue date upon the occurrence of an event of default complying with GENPRU 2.2.159R(2) (limited to non-payment of any amount falling due under the terms of the capital instrument or the winding-up of the issuer).

QIS 5 does not address the question of redemption upon an event of default. However, it would not seem tenable for the rules to prohibit a holder enforcing his claims where the issuer is either unwilling or unable to discharge its payment obligations or is in the process of being wound up.

In other jurisdictions, such as Germany, there have so far not been any rules or regulations stipulating the requirements for the various tiers of own funds of a (re)insurer. So issues of:

- subordinated debt under Article 27(3)(a) of the Consolidated Life Directive or Article 16(3)(a) of the First Non-Life Directive (as amended) ("subordinated debt"); and
- undated subordinated debt with no specified maturity date ("perpetual securities") under Articles 27(3)(b) and 16(3)(b) of the same Directives

have been made under more widely varying terms in those jurisdictions. Subject to any additional terms, it is likely that debt complying with the requirements for either of these categories under the Directives will meet the QIS 5 requirements for grandfathering as Tier 2 own funds under Solvency II. The draft Tier 1 requirements are less obviously going to be satisfied. With no ability to cause or accelerate insolvency, perpetual securities may well be grandfathered as Tier 1 own funds. Subordinated debt would, in addition, need to be perpetual (the (re)insurer having the option to redeem subject to regulatory approval) with no incentives to redeem before 10 years and the ability to defer coupons in order to be grandfathered as Tier 1.

All German deals make the exercise by the issuer of its call right subject to prior replacement by other own funds of at least equal or better quality or, alternatively, prior approval by the regulator. The draft requirements for grandfathering as Tier 1 require a contractual obligation to replace the capital so it should be open to issuers to forego the right to seek regulatory approval for a deal which has a call prior to 10 years, thereby allowing that deal to qualify for Tier 1 (if all the other Tier 1 requirements are met). We would hope though that the criteria can be clarified before the transitional provisions are finalised.

It will, in any event, be necessary to monitor the transitional provisions as they develop and are finalised – and to consider carefully the individual terms of each instrument or agreement to confirm whether it will be grandfathered.

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