Solvency II – Eligibility of Contingent Capital

This article will discuss and analyse contingent capital within the current Solvency II framework, both from its current position and also potential developments in how it will be assigned as a risk absorbing instrument.

Contingent Capital Overview

Contingent capital is an option which allows the purchaser the right to raise capital from the option supplier on predefined conditions at or after the occurrence of a specific event or series of events. An example of such an event or "trigger" would be total losses exceeding a pre-arranged limit within a specific period of time.

The form of capital provided at the trigger point is pre-arranged and could for example be structured as an equity/debt security purchase or loan provision.

Own Funds – Contingent Capital

Within the Solvency II framework "Own funds" are a company's qualifying capital that are eligible to cover its capital requirements (MCR and SCR).

A company's "Own Funds" are split between three tiers depending on how well they can absorb losses emanating from risks written. Tier 1 is the highest quality capital and tier 3 is the least. tiers 2 and 3 are split into two different forms; "Basic Own Funds" and "Ancillary Own Funds".

As an option, contingent capital is classified as "Off Balance Sheet" and as such classed within ancillary own funds for the purposes of Solvency II (with the exception of "Budgeted Supplementary Member Calls"). Below are the categorisations of each aspect of contigent capital taken from the latest technical specifications of Quantitative Impact Study 4.

Tier 1 Own Funds – Contingent Capital

- ***"Budgeted supplementary calls*** *that mutual undertakings can make on their members are eligible for inclusion in the excess of assets over liabilities."*

Tier 2 Ancillary Own Funds – Contingent Capital

- ***"Unpaid and callable hybrid capital instruments*** *(otherwise) eligible for inclusion in tier 1."*

- *"Part of the amount of* ***unbudgeted supplementary member calls*** *by mutual undertakings."**

Tier 3 Ancillary Own Funds – Contingent Capital

- *“**Unpaid and callable hybrid capital instruments** (otherwise) eligible for inclusion in tier 2 or tier 3.*
- ***Supplementary member calls** of mutual undertakings not eligible for inclusion in tier 2.”** *QIS4 Technical Specifications, page 99 – page 102*

The Supplementary Member Calls are assigned in a different manner

**“These calls are subject to recovery risk, as the callable amount might not be fully received following a call. It is also possible that receipt is delayed so that the claim is not available immediately to cover losses. As a consequence, only part of unbudgeted supplementary member calls can be classified in tier 2 ancillary own funds, being calls, the recoverability of which is considered certain.*

For QIS4, 40 % of the maximum callable amount specified in the statutes of the mutual company can be classified in tier 2 ancillary own funds, and the rest in tier 3 ancillary own funds.” QIS4 Technical Specifications, page 102

Own Fund Eligibility

The eligibility of own funds to cover the necessary Solvency II capital requirements are as follows:

Minimum Capital Requirement (MCR)

- Can only be comprised of tier 1 and tier 2 Basic own funds
- Total tier 1 funds must be greater than or equal to the sum of all tier 2 funds i.e. $\sum tier1 \geq \sum tier2$

Solvency Capital Requirement (SCR)

- Can be comprised of tier 1, tier 2 and tier 3, both basic and ancillary own funds with the following restrictions
- At least one third of the SCR is tier 1 capital i.e. $\sum tier1 \geq \frac{1}{3} SCR$
- Total of tier 2 and tier 3 capital must not exceed twice the level of tier 1 capital i.e. $2 \bullet \sum tier1 \geq \sum (tier2 + tier3)$
- Total tier 3 capital must not exceed one third of the SCR i.e. $\sum tier3 \leq \frac{1}{3} SCR$

With the majority of contingent capital being classified in tier 2 and 3 ancillary own funds, it is for the most part not eligible to cover the MCR. With the restrictions above, it can however be used to cover the gap between MCR and SCR.

Quantitative Impact Studies (QIS)

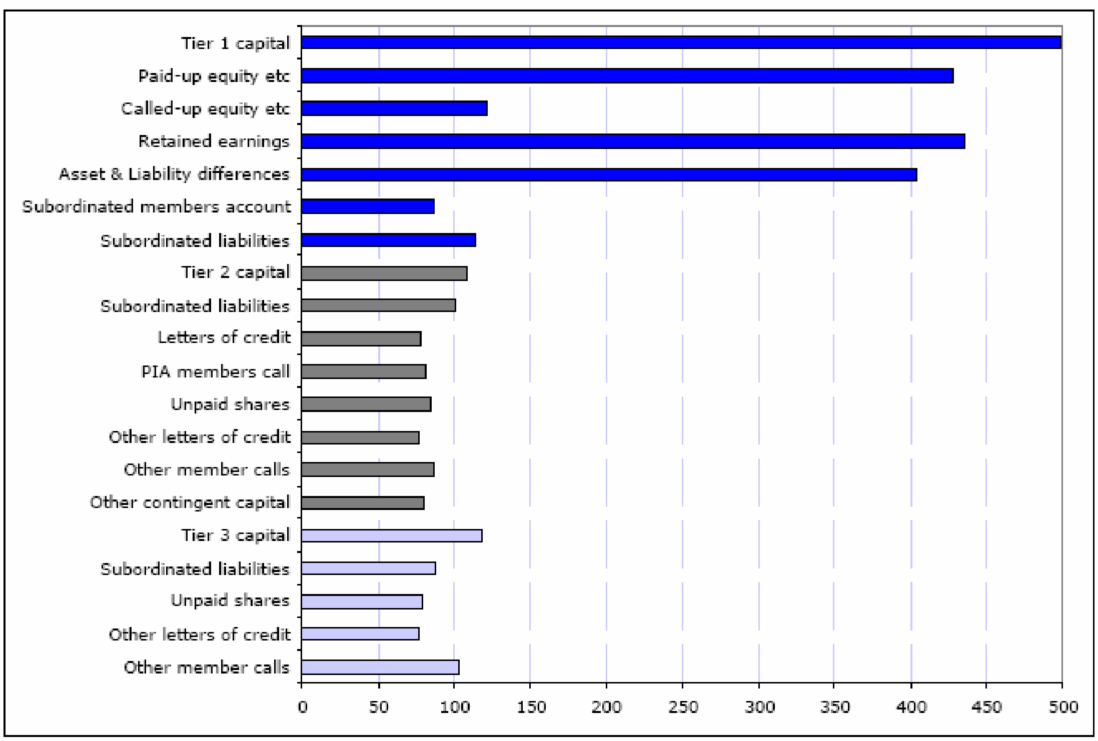
The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has so far run four impact studies involving the testing of Solvency II within the European insurance market. The two most recent Quantitative Impact Studies (QIS3 and QIS4) both tackled the area of Solvency II and collected data on the markets usage of contingent capital within own funds.

QIS3 – Contingent Capital

- Responses to QIS3 in relation to placing the various forms of contingent capital in the correct tier were varied.
- There was a large degree of confusion, especially with regards to distinguishing between tier 2 and 3.

"One respondent noted that clearer definitions were needed for classifying contingent items as tier 2 or tier 3" Pg171, Paragraph 1, CEIOPS QIS3 Report

Below is a breakdown of the number of participants (in QIS3) using the various forms of capital in QIS 3, including the various forms of contingent capital.



CEIOPS QIS3 Report Pg127

QIS4 – Contingent Capital

Improvements in classification of own funds were made in QIS4 and the final report provided a more in depth analysis than its predecessors. This was particularly the case with categorisation of ancillary own funds which, as mentioned above, had proved to be a cause of some inconsistency in QIS3.

With the increased clarity from the detailed own fund classifications present in QIS4, CEIOPS were able to produce more detailed analysis of the participants' funds. Proportions of the various forms of capital making up tier 2 and tier 3 (where the majority of contingent capital is classed) can be seen in the diagrams below (taken from the CEIOPS QIS4 Report).

Figure 55: Composition of Tier 2 (all undertakings)

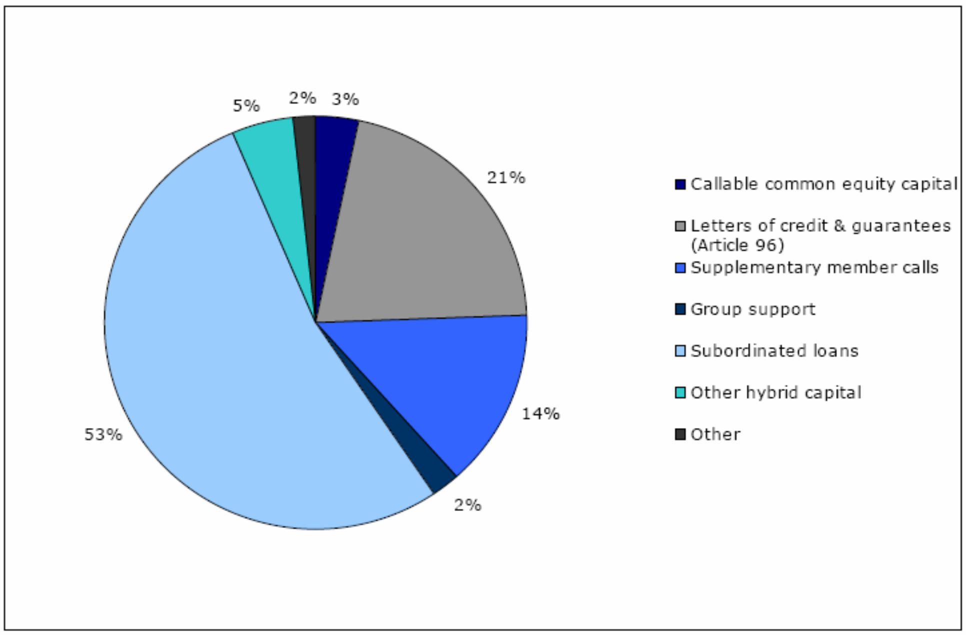
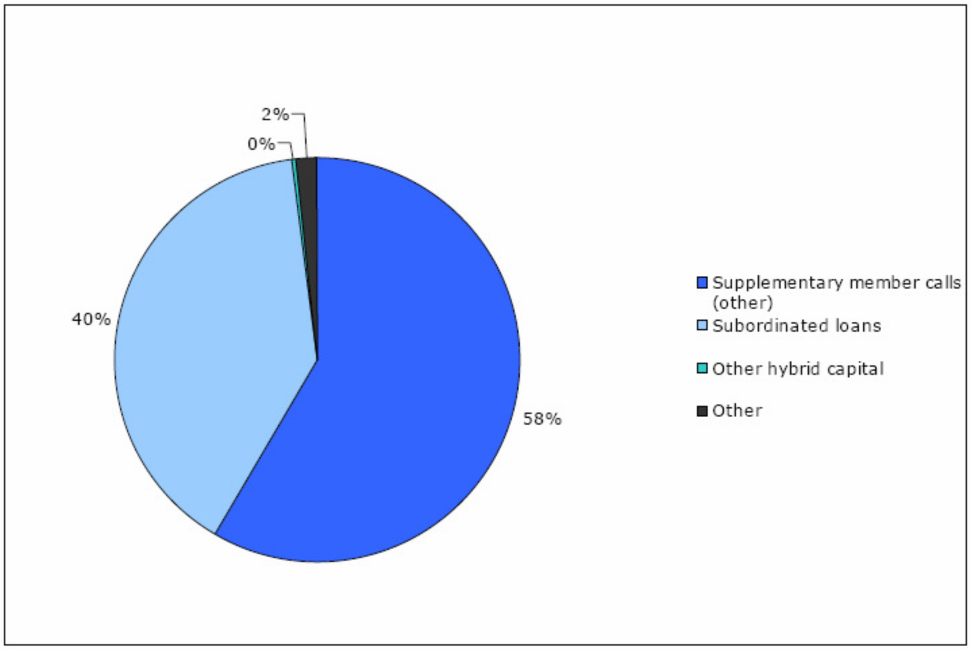


Figure 56: Composition of Tier 3 (all undertakings)



CEIOPS QIS4 Report – Pg 132

The only form of contingent capital that is specifically named is unbudgeted supplementary member calls (with the 40%:60% split between tier 2 and tier 3) which make up a substantial proportion of tier 2 and tier 3 capital.

Of the large amount of subordinated loans present in both tiers 2 and 3, a proportion will be unpaid (contingent), both perpetual and dated, though no exact breakdown is provided in the report.

Although ancillary own funds make up a small percentage of total own funds as a whole (less than 10% of own funds in each country), they and particularly contingent capital can be a useful tool for providing capital adequacy in the layer between MCR and SCR. As below certain countries use these instruments to a greater extent due to the make up of their insurance sectors.

"When analysing the breakdown in each country, it is important to highlight the relevance of unpaid subordinated loans, letters of credit and guarantees, supplementary member calls (DE, FI, FR), group support, supplementary member calls" CEIOPS QIS4 Report pg156

QIS5 and beyond – Contingent Capital

Moving on from the results of QIS4, it is expected that further information will be requested from industry participants by CEIOPS in QIS5 (starts in August 2010), particularly regarding the precise composition of their own funds. Classification of contingent capital within the Solvency II framework has certainly become more detailed in QIS4, although convergence and further detail is still required. The diverse capital structures, found in companies covered by Solvency II both at the structural and geographic level has to be taken into account.

With the likely increase in industry participation for QIS5, as well as further clarity stemming from the results of QIS4, a more complete understanding across the sector of contingent capital's place within Solvency II can be expected. As a valuable tool to a wide range of entities covered under Solvency II, it is essential for contingent capital to be accurately incorporated within the framework.

For more information on Solvency II please visit our website – www.scandinaviancs.com