

CEA Paper on the treatment of Ancillary Own Funds

CEA reference:	ECO-SLV-09-057	Date:	19 February 09
Referring to:	Ancillary Own Funds		
Related CEA documents:	/		
Contact person:	ECOFIN Department	E-mail:	ecofin@cea.eu
Pages:	4		

1. Introduction

In the draft framework Directive and QIS 4 the EC and CEIOPS are describing the characteristics for own funds. In the directive a split is made between basic own funds and ancillary own funds. Next to this split three tiers are recognised. Based on the following criteria a certain list has been drafted:

- 1 subordination of total amount on winding-up;
- 2 full loss-absorbency in going concern;
- 3 undated or of sufficient duration (perpetuality);
- 4 free from requirements/incentives to redeem the nominal amount;
- 5 absence of mandatory fixed charges;
- 6 absence of encumbrances.

The CEA has already commented on these criteria in their position papers published in 2008.

This document will focus on the recognition and measurement of the ancillary own funds. In March CEIOPS aims at publishing an "Implementing measure document" for this topic.

If due to the current negotiations between the European Parliament and Council Group Support is regarded as ancillary own funds, CEA will re-assess the principles as presented in this document.

2. Directive and QIS 4

QIS 4

In QIS 4 CEIOPS / EC have presented the following:

TS.V.E. Ancillary own funds

TS.V.E.1 For all ancillary own fund items, the characteristics and key features should apply to the basic own fund item that arises once the ancillary own fund item has been called up.

- The status of the counterparty concerned, in relation to their ability and willingness to pay
- The recoverability of the funds
- Historical evidence

Draft framework directive

In the framework Directive the following is said regarding own funds (explanatory memorandum):

Own funds –Articles 86 to 99

Own funds correspond to a (re)insurance undertakings' available financial resources which can serve as a buffer against risks and absorb financial losses, where necessary. The determination of the amounts of own funds eligible to cover the two capital requirements is based on a three-step process. Each step corresponds to a subsection: determination of own funds, classification of own funds, eligibility of own funds.

In a first step, the amounts of available own funds must be identified. Own funds are the sum of:

- items on the balance-sheet, or "basic own fund items" (see Article 87);
- items not on the balance-sheet, or "ancillary own fund items" (see Article 88).

Basic own funds comprise the economic capital (i.e. the excess of assets over liabilities, valued in accordance with Sections 1 and 2) and subordinated liabilities (as those liabilities can serve as capital, for instance in the case of winding-up).

Ancillary own funds comprise commitments that undertakings can call upon in order to increase their financial resources, such as members' calls and letters of credit. As those ancillary own funds do not fall under the valuation standards provided for in Sections 1 and 2, the determination of their amounts is subject to prior supervisory approval.

In a second step, as own fund items possess different qualities and provide for different levels of absorption of losses, those own fund items will be classified into three tiers, depending on their nature and the extent to which they meet five key criteria (i.e. subordination, loss-absorbency, permanence, perpetuity and absence of servicing costs), as set out in Article 93.

The classification of own funds into tiers relies on qualitative criteria to be further specified through implementing measures (see Article 97); however, in order to facilitate that classification, a list of pre-classified items will also be laid down in those implementing measures.

Nature \ Quality	On the balance sheet	Off the balance sheet
High	Tier 1	Tier 2
Medium	Tier 2	Tier 3
Low	Tier 3	-

In a third step, as Tier 2 and Tier 3 items do not provide for full absorption of any losses in all circumstances, it seems necessary to limit their recognition for supervisory purposes. As set out in Article 98, two sets of limits apply to available own funds, in order to determine the amounts eligible for supervisory purposes:

- With respect to the Solvency Capital Requirement, the proportion of Tier 1 in the eligible own funds should reach at least 1/3, and the proportion of Tier 3 should be no higher than 1/3.
- With respect to the Minimum Capital Requirement, ancillary own fund items are not eligible, and the proportion of eligible Tier 2 items should be limited to ½.

Article 88

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 fund items: (a) unpaid share capital or initial fund that has not been called up, as referred to in Article 91; (b) letters of credit; (c)
2. any other 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 financial year concerned.
3. 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 89

Supervisory approval of ancillary own funds

1. The amounts of ancillary own fund items to be taken into account when determining own funds shall be subject to prior supervisory approval.
2. For each ancillary own fund item, supervisory authorities shall base their approval on an assessment of the following: (a) the status of the counterparties concerned, in relation to their ability and willingness to pay; (b) the recoverability of the funds, taking account of the legal form of the item, as well as any conditions which would prevent the item from being successfully called up; (c) any information on the outcome of past calls which insurance and reinsurance undertakings have made for such ancillary own funds.
3. The amount of each ancillary own fund item shall be equal to its nominal value unless either of the following conditions are fulfilled: (a) the item does not have a nominal value or has a maximum nominal value; (b) the nominal value does not reflect the loss-absorbency of the item. In those cases, the amount of the item to be taken into account for the determination of ancillary own funds shall be based upon prudent and realistic assumptions.
4. Supervisory authorities shall approve either of the following: (a) a monetary amount for each ancillary own fund item; (b) a method to determine the amount of each ancillary own fund item, in which case supervisory approval of the amount determined in accordance with that method shall be granted for a specified period of time.

3. Treatment of ancillary own funds

Ancillary own funds are typically constructions which are not recognised on the balance sheet of an insurer but are commitments of other parties towards the insurer.

Because the constructions and possible commitments are so diverse a principle based approach should be used. Flexibility is necessary and should not be suppressed by detailed rules:

- If an insurer is using an instrument normally recognised as an ancillary own fund, such as a letter of credit or a guarantee¹, the supervisor will provide an endorsement decision afterwards; If the insurer is using other instrument as ancillary own funds then the insurer should get an endorsement of the supervisor before the insurer is able to recognise the ancillary own fund; The supervisor should present his answer as quickly as possible but within one months after the application has been made;

¹ These should be based on commonly used formats and standards and could be part of level 2 implementing measures.

- When an insurer is making his request, the following items should be included in the assessment of the supervisor:
 - What is the nature of the ancillary own fund?
 - What is the financial position of the counter party providing the ancillary own fund?
 - An analysis of the effectiveness and ability to comply?
 - Relationship between the insurer and the counterparty?
- What is the appropriate method for the measurement of the ancillary own fund? An economic approach should be taken based on the characteristics and key features which apply to the basic own fund item that arises once the ancillary own fund item has been called up;
- Supervisory reporting: a description of the nature and measurement of the own funds; Public disclose: a general description of the existence of the ancillary own funds as part of the disclosure regarding own funds according to Art. 50 (1) e) (i);
- After the endorsement decision to allow the ancillary own funds, each year the effectiveness and appropriateness of the ancillary own funds will be assessed as part of the ORSA;
- If due to the current proposed tiering-limits there is not enough room for the ancillary own fund, which is subject to approval, the endorsement should proceed and be considered as a 'pre-endorsement' to be used when an existing recognised ancillary own fund is expired or is revoked.

The recognition of ancillary own funds should only be refused if:

- The economic measurement of the ancillary own funds cannot be reliably done;
- The effectiveness of the ancillary own funds is very doubtful.

About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, e.g. pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 065bn, employ over one million people and invest more than €6 900bn in the economy.