REPORT ON THE USE OF CAPITAL ADD-ONS DURING 2019

European Insurance and Occupational Pensions Authority

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EXECUTIVE SUMMARY

The objective of the capital add-on measure is to ensure that the regulatory capital requirements reflects the risk profile of the undertaking or of the group. Therefore, it is important that it is used by national competent authorities (NCAs) when needed and it is important to ensure a high degree of supervisory convergence.

The analysis in this report addresses the capital add-ons set during 2019 to solo undertakings or insurance groups from the 30 EEA countries (or members) and from the UK.

The setting of capital add-ons follows the process as described in Article 37 of the Solvency II Directive.

All NCAs reported no changes to the internal process of setting and reviewing capital add-ons and the vast majority has no formal policies in place. Most NCAs find the current legislation and regulation, including the content of the Implementing Regulation, sufficient and adequate for the purpose of setting capital add-ons.

During 2019, nine NCAs have set capital add-ons to 19 solo undertakings, out of 2816 (re)insurance undertakings under the scope of the Solvency II Directive in the EEA and UK. These include nine non-life undertakings, five life undertakings, four reinsurance undertakings and one composite undertaking. In 2018, eight NCAs had set capital add-ons for a total of 21 solo undertakings including 10 non-life undertakings, eight life undertakings, one reinsurer and two composites.

The amount of capital add-ons imposed on undertakings using the standard formula remains very low overall in 2019 (i.e. the relative size of the capital add-on is less than 0.5% of the total SCR in total), but it is not insignificant when considering the amount at individual level. In total, considering those undertakings with capital add-ons using the standard formula, the weight of the capital add-on increased on average to 38% in 2019.

However, the distribution of the capital add-ons as a percentage of the total SCR in 2019 for undertakings that imposed capital add-ons varies substantially. In 2019, the largest percentage is 81%, whereas the smallest percentage is rounded close to 0%. It should be noted that in all but four cases, the capital add-on increases the SCR by more than 10%.

1. BACKGROUND

The report on the use of capital add-ons is an Annual Report[1] that EIOPA publishes, in accordance with Article 52(3) of the Solvency II Directive[2], in order to report to the European Parliament, the Council and the Commission the degree of supervisory convergence in the use of capital add-ons between supervisory authorities in different Member States.

According to Article 37 and 232 of the Directive 2009/138/EC (hereinafter Solvency II Directive) NCAs have the possibility to set capital add-ons for solo undertakings (life, non-life, composite or reinsurance) or for the insurance group. The capital add-on should ensure that the solvency capital requirement properly reflects the overall risk profile of the insurance undertaking, reinsurance undertaking or group. As such, it is important that it is used by National Competent Authorities (NCAs) when needed, and it is important to ensure a high degree of supervisory convergence between NCAs within the European Economic Area (EEA) members. This report addresses the supervisory convergence during 2019 and therefore includes the EEA members and the UK regarding the use of capital add-ons.

Following the supervisory review process, NCAs may in exceptional circumstances set a capital add-on by a decision stating the reasons. That possibility exists only where there has been a significant: :

- deviation of the risk profile from the standard formula assumptions (Article 37(1) a of Solvency II);
- Deviation of the risk profile from the internal model assumptions (Article 37(1) b) as quantifiable risks are insufficiently captured and failure of the adaptation of the model to better reflect the given risk profile within an appropriate timeframe;
- deviation from the required governance standards (Article 37(1) c);
- deviation of the risk profile from assumptions the volatility or matching adjustment or transitional measures following the application of any of these adjustments or measures (Article 37(1) d).

Capital add-ons are to be considered only when other measures have failed, are unlikely to succeed or are not feasible. The term exceptional should be understood in the context of the specific situation of each undertaking rather than in relation to the number of capital add-ons imposed in a specific market.

The Solvency II Directive also mentions that the capital add-on shall be reviewed at least once a year by the supervisory authority and be removed when the undertaking has remedied the deficiencies which led to its imposition.

The capital add-on shall be proportionate to the material risks arising from the different risk profile or deficiencies which gave rise to the decision of the supervisory authority to set the capital add-on.

In this report emphasis is put in particular on changes on the usage of capital add-ons as reported with regard to the last year's report.

1 The 2019 report can be consulted on EIOPA's website: https://www.eiopa.europa.eu/content/eiopa-publishes-annual-report-use-capital-add-ons-under-solvency-ii_en?source=searchhttps://eiopa.europa.eu/Pages/News/EIOPA-publishes-second-annual-report-on-the-use-of-capital-add-ons-under-Solvency-II.aspx. It will be published for the 5th time this year and includes UK data for the transitional period of the Brexit.

2 Directive 2009/138/EC of 25 November 2009 of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

2. DATA SOURCES

The analysis in this report is based on 2019 year-end Solvency II Quantitative Reporting Templates (QRTs)[3] submitted by the solo undertakings or insurance groups from the 30 EEA countries (or members) and from the UK.

Additionally, EIOPA launched a survey for NCAs that included both qualitative and quantitative questions on the use of capital add-ons.[4]

With regard to the quantitative section of the survey, information on the number of capital add-ons set per solo undertaking or per group as well as the reason which led to set the capital add-on (information not available in the QRTs) was requested.

The survey also included qualitative questions on the use of the capital add-ons, focusing on changes in comparison to the last year, to gain a better understanding of the process of setting, calculating and reviewing the capital add-ons, as the limited use of this tool might be mostly due to the complexity of the process that inhibits NCAs from setting capital add-ons.

In this regard, the qualitative section aims to support the understanding of the circumstances where capital add-ons were used in order to contribute to a higher degree of supervisory convergence in the different Member States.

The graphs and tables with the number of undertakings and groups used in this report are based on the information obtained from the QRTs complemented with the information collected in the survey.

3 Templates S.25.01, S.25.02 and S.25.03 (on the Solvency Capital Requirement and S.23.01 on Own Funds.

4 All but one NCA submitted the survey. This NCA does not use any capital add-ons.

3. CHANGES ON PROCESSES AND POLICIES

As a tool affecting the level of the Solvency Capital Requirement, EIOPA acknowledges that the convergence of supervisory practices, particularly in the case of capital add-ons is crucial to guarantee a level playing field for all the undertakings.

The setting of capital add-ons follows the process as described in Article 37 of the Directive. The assessment entails if the standard formula or partial internal model is adequately capturing the risk profile of the undertaking, including the use of volatility or matching adjustment or transitional measures and also taking into account the ORSA and if any deficiencies on the system of governance have been identified.

All NCAs reported no changes to the internal process of setting and reviewing capital add-ons and the vast majority has no formal policies in place. After 4 years of implementation of Solvency II, it could be expected that more NCAs have formal processes in place. Of the NCAs who set capital add-ons only two have formal policies in place. Some NCAs operating in small markets pointed out to apply case by case decisions. This might suggest that NCAs find the current regulation in fact sufficient and adequate for the purpose of setting capital add-ons, including the content of the Implementing Regulation.[5]

This applies to both solo undertakings and groups.

Each capital add-on shall be reviewed at least once a year by the supervisory authority and be removed when the undertakings have remedied the deficiencies, which led to its imposition.

This requires pro-active monitoring of the situation that led to the imposition of the capital add-on by both NCAs and the relevant undertaking or group. The undertaking or group shall provide progress reports to their supervisory authority if required by the NCA in accordance with Article 37 (10 (b) and (c)).However, the majority of NCAs don't have formal policies in place and highlight explicitly they don't foresee any changes in this regard in the future. Hence, the result of last year's survey is still valid.

5 Commission Implementing Regulation (EU) 2015/2012 of 11 November 2015 laying down implementing technical standards with regard to the procedures for decisions to set, calculate and remove capital add-ons in accordance with Directive 2009/138/EC of the European Parliament and of the Council.

4. DISCLOSURE

According to Article 31 of the Solvency II Directive and Article 316 in connection with Annex XXI of the Delegated Regulation, NCAs that set capital add-ons have to disclose in particular the following:

- The number of capital add-ons, the average capital add-on per undertaking and the distribution of capital add-ons measured as a percentage of the Solvency Capital Requirement, with regard to all insurance and reinsurance undertakings supervised under Directive 2009/138/EC;[6]
- The criteria used for the application of capital add-ons and the criteria for their calculation and removal.[7]

Out of a total of nine NCAs that set capital-add-ons, eight NCAs were fully transparent in their disclosure and provided web links on capital add-ons used and disclosed the amount of the capital add-on as well as explanations why they set a capital add-on. One NCA did not provide a link to their website as such but indicated at the same time that the capital add-ons were published by the concerned undertakings in their SFCR. It should be noted that the disclosure by undertakings of the capital add-ons in their SFCR, according to Article 51(2) of the Solvency II Directive, does not replace the obligation of the NCA to include capital add-ons in the statistics to be publicly disclosed in accordance with Article 31 of the Solvency II Directive.

According to Article 51(2) of the Solvency II Directive, Member States may exercise the option to temporarily limit the public disclosure by each insurance and reinsurance undertaking within their annual Solvency and Financial Condition Report (SFCR) of the capital add-ons set. The information on the capital add-on will become obligatory on a public basis for undertakings and insurance groups on an annual basis only from December 2020 onwards. This means that the first SFCRs expected to have information on capital add-ons are the ones addressing the financial year end after the end-December 2020, i.e. the SFCR regarding the end of 2021 and published in 2022 for the majority of the market.

EIOPA will continue to monitor the disclosure of capital add-ons.

6 Annex XXI – Part A, point 23 of the Solvency II Delegated Regulation.

7 Annex XXI – Part B, point 8 of the Solvency II Delegated Regulation.

5. NUMBER OF CAPITAL ADD-ONS FOR SOLOS

During 2019, nine NCAs have set capital add-ons to 19 solo undertakings, out of 2816 (re)insurance undertakings under the Solvency II Directive in the EEA and UK. These include nine non-life undertakings, five life undertakings, four reinsurance undertakings and one composite undertaking. In 2018, eight NCAs had set capital add-ons for a total of 21 solo undertakings including 10 non-life undertakings, eight life undertakings, one reinsurer and two composites.

Capital add-ons are set under Article 37 (a), Article 37(b), Article 37(c) and Article 37(d) (Table 1.1).

The overall usage of setting capital add-ons remains very low.

As the knowledge and especially corresponding experience will be developed over time, it should lead to more cases of capital-add-ons and ensure therefore a more efficient use of this tool.

As stated by some NCAs using capital add-ons as a supervisory tool was often impaired and other supervisory tools were used due to the following reasons:

1. A negative image is still assigned to this supervisory tool;
2. NCAs supervisory judgment is needed to calculate capital add-ons, as measuring the amount of significant deviations, be it for the SCR amount or for governance deficiencies, is complex and subject to potential long and difficult negotiations;
3. The use of the capital add-ons is still linked to the level of capitalisation of the market, albeit the Solvency Capital Requirement (SCR) should reflect all risks an undertaking faces and should correspond to a Value-at-Risk of the basic own funds of an undertaking subject to a confidence level of 99.5% over a one-year period;
4. The set of capital add-ons could be challenged in court leading to potentially long and complex legal disputes.

The difficulty encountered by NCAs in deciding and setting capital add-ons is demonstrated by the fact that in 2019 the set of capital add-ons was challenged in court in two cases leading to long and complex processes which do not benefit the supervisory process or the use of such a tool.

The following table provides an overview of the number of capital-add-ons set at solo level in 2019 (under the conditions referred to in Article 37 of the Directive) and in which countries they were imposed). Similarly to previous years, cases of so called "self-imposed" capital add-ons were observed again in 2019, but at a residual level. These are not considered as capital add-ons as they were not set by the NCAs.[8]

8 More detailed information on self-imposed capital add-ons is available in the previous report published here: https://www.eiopa.europa.eu/content/report-use-capital-add-ons-during-2018_en

Table 1.1: Capital add-ons at solo level in 2019

	Total	Imposed under Article 37 (1) a[9]	Imposed under Article 37 (1) b[10]	imposed under Article 37 (1) c[11]	Imposed under Article 37 (1) d[12]
Total	19	13	3	2	1
Life	5	4	1		
Non-life	9	7		1	1
Reinsurance	4	2	2		
Composite	1			1	

Table 1.2: Capital add-ons at solo level in 2019 by country

	Total capital add-ons	Life under-takings	Non-life undertakings	Reinsurance undertakings	Composite
	2019 (2018)				
Total	19(21)	5	11	2	1
Cyprus	1 (1)				1
Denmark	1 (0)		1		
Finland	1 (1)		1		
France	2 (2)	1	1		
Ireland	1 (1)		1		
Italy	1 (1)		1		
Norway	2 (2)		2		
Spain	1 (1)	1			
UK	9 (12)	3	4	2	

9 Standard formula significant risk profile deviation.

10 Internal model significant risk profile deviation.

11 Significant system of governance deviation.

12 Significant risk profile deviation following the application of the matching adjustment, volatility adjustment or transitional measure.

6. NUMBER OF CAPITAL ADD-ONS FOR GROUPS

In the EEA and UK insurance market 561 groups are under supervision according to Solvency II. A capital add-on to the consolidated group SCR might be set when the risk profile of the group is not reflected adequately.

In 2019, as last year, only one NCA set group capital add-ons, two for deviations with the risk profile for standard formula users and one to a group using an internal model.

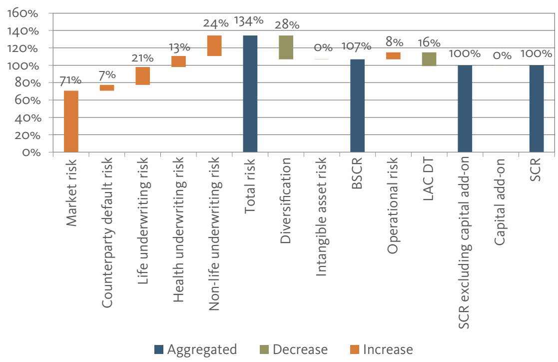
Table 1.3: Capital add-ons at group level in 2019 by country

Country	Number of CAOs	imposed under Article 37(1)(a)	imposed under Article 37(1)(b)	imposed under Article 37(1)(c)	imposed under Article 37(1)(d)
UK	3	2	1		

7. AMOUNT OF CAPITAL ADD-ONS

Also the amount of capital add-ons imposed on undertakings using the standard formula remains very low overall in 2019 when compared to total SCR at EEA and UK level. It amounts to less than 0.5% (rounded 0%) of the total SCR at EEA and UK level (Figure 1.1).

Figure 1.1.: Main Components of SCR for all undertakings using the standard formula in 2019 [13]



However, the amount of capital add-on is not insignificant when considering the amount at individual level.

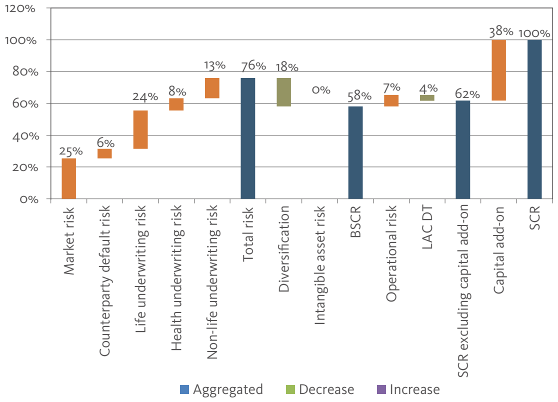
In total, considering those undertakings with capital add-ons using the standard formula, the weight of the capital add-on increased to 38% in 2019 (32% in 2018).

Due to the low number of capital add-ons, the amount of the capital add-ons is assessed as the percentage of total SCR for those insurance undertakings that have capital add-ons.

When doing this analysis, the weight of the capital add-on increases to 38% and becomes one of the main drivers of the SCR (Figure 1.2).

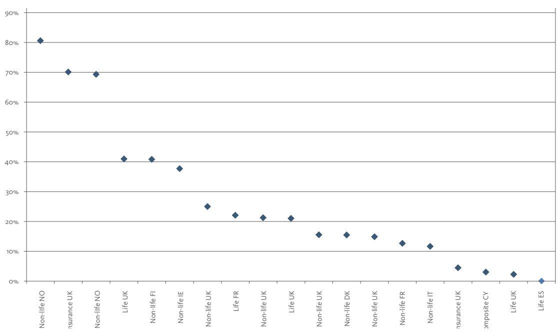
13 For one undertaking the QRT reporting is not available as it is under administration.

Figure 1.2.: Main Components of SCR for insurers using the standard formula with capital add-on in 2019 [14]



The distribution of the capital add-ons as a percentage of the total SCR in 2019 for undertakings that imposed capital add-ons varies substantially once more. In 2019, the largest percentage is 81% (80% in 2018), whereas the smallest percentage is rounded close to 0% (0% in 2018). It should be noted that in all but four cases (five cases in 2018) the capital add-on increases the SCR by more than 10% (Figure 1.3).

Figure 1.3.: Distribution of the individual CAOs as a percentage of total SCR in 2019 for undertakings with imposed capital add-ons



As in 2018, the cases where the capital add-ons represent the highest percentage of the SCR correspond to cases where the standard formula does not capture the catastrophe risks undertakings are exposed to, namely the unsystematic risks stemming from war-related insurance cover and pharmaceutical liability cover, highly specialised niche undertakings.

14 For one undertaking the QRT reporting is not available as it is under administration.

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