

REPORT ON THE USE OF CAPITAL ADD-ONS DURING 2018

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EXECUTIVE SUMMARY

The objective of the capital add-on measure is to ensure that the regulatory capital requirements reflect 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 between NCAs within the 31 European Economic Area Member States, including the EU Member States, regarding its use.

This analysis is based on 2018 year-end Solvency II data collected under Directive 2009/138/EC as reported by the undertakings and insurance groups complemented by a survey that entailed both qualitative and quantitative questions.

All 31 NCAs reported no changes in the internal process of setting and reviewing capital add-ons for solo undertakings, including solo undertakings that are part of a cross-border group.

The majority of NCAs do not have formal policies in place and the overall use of capital add-ons remains extremely limited. During 2018, eight NCAs set capital add-ons to 21 solo insurance and reinsurance undertakings, and one NCA used it for three groups. These include 10 non-life undertakings, eight life undertakings, two reinsurers and one composite.

When used, capital add-ons have a material impact on the solvency capital requirement (SCR) of some of the entities, increasing it by more than 10% in all cases (with the exception of five). In fact, in 2018, the distribution varies highly with the largest weight of the capital add-on being 80% and the smallest weight being close to 0%.

Article 31 of the Solvency II Directive and the provisions of related delegated regulations requires NCAs that set capital add-ons to disclose 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 SCR, with regard to all insurance and reinsurance undertakings supervised under Directive 2009/138/EC. Out of the eight NCAs that set capital add-ons in 2018 this information was disclosed by all NCAs on their websites.

According to the regulatory framework, capital add-ons are to be used as a measure of last resort, when they are exceptional and transitory and should be considered only when other supervisory measures have failed, are unlikely to succeed or are not feasible. This context contributed to the current limited use of this tool with NCAs recognising that additional capital add-ons should have been set from a prudential point of view but that they had not done so because of the complexity of the process. In this sense, a streamlining/simplification of the process for setting capital add-ons would allow better use of this tool.

1. BACKGROUND

The 2019 report on the use of capital add-ons is an annual report¹ that EIOPA publishes, in accordance with Article 52(3) of the Solvency II Directive², 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 the various Member States.

According to Articles 37 and 232 of Directive 2009/138/EC (hereafter the Solvency II Directive) NCAs have the possibility of setting capital add-ons for solo undertakings (life, non-life, composite or reinsurance) or for the insurance group.

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 assumption (Article 37(i)(a));
- deviation of the risk profile from the internal model assumptions (Article 37(i)(b));
- deviation from the required governance standards (Article 37(i)(c));
- deviation of the risk profile from assumptions following the application of the volatility or the matching adjustment or of transitional measures (Article 37(i)(d)).

Capital add-ons should be considered 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 states that the capital add-on should be reviewed at least once a year by the supervisory authority and be removed when the undertaking has remedied the deficiencies that led to its imposition.

The objective of such a measure is to ensure that the regulatory capital requirements (solvency capital require-

ment, SCR) reflects the risk profile of the undertaking or the group.

The capital add-on should be proportionate to the material risks arising from the different risk profiles or deficiencies that 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 in the use of capital add-ons reported over the past three years.

2. DATA SOURCES

The analysis in this report is based on 2018 year-end Solvency II quantitative reporting templates (QRTs)³ submitted by solo undertakings or groups from the 31 Member States of the European Economic Area (EEA) to their NCAs.

In addition, EIOPA launched a survey for NCAs that included both qualitative and quantitative questions on the use of capital add-ons.

With regard to the quantitative section of the survey, the number of capital add-ons set per solo undertaking or per group was requested regarding the types of deviations set out in Article 37 (information not available in the QRTs).

The survey also included qualitative questions on the use of the capital add-ons to gain a better understanding on the process of setting, calculating, reviewing and/or retaining the capital add-ons. The qualitative section aimed to support understanding of where capital add-ons were used to contribute to a higher degree of supervisory convergence in the various Member States.

The qualitative questions focused on changes in comparison with previous years and included among others:

- questions on the overall use of capital add-ons for solos and groups;
- questions on formal policies in place and their disclosure;
- reasons for setting capital add-ons and how to calculate them.

¹ The 2017 and 2018 reports can be consulted on EIOPA's website.

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).

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

The graphs and tables, showing 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. PROCESSES AND FORMAL POLICIES FOR SETTING CAPITAL ADD-ONS

Based on the answers to the dedicated survey, the following observations can be made regarding the changes in NCAs processes and formal policies for setting capital add-ons.

None of the NCAs reported changes in the internal process of setting and reviewing capital add-ons for solo undertakings including solo undertakings that are part of a cross-border group.⁴

According to the survey answers, the processes that were implemented in accordance with Article 250(1)(c) of the Solvency II Directive for groups are also unchanged, as they were implemented 3 years ago. For one NCA, this is because annual reviews are used for updating capital add-ons or setting notifications. However, it should be stressed that this does not require reassessing the general processes around the setting of the capital add-on.

In addition, as confirmed by several NCAs, consulting processes established by the college of supervisors proved to be useful when consulting the group supervisor before a capital add-on decision was made.

Setting capital add-ons should be implemented in the context of an on-going supervisory dialogue, which requires proactive monitoring by the NCAs. This means that the undertaking or group should report any significant deviations it detects in accordance with Article 37(1) (a) to (d).

According to the Solvency II Directive, if required by the supervisory authority, the insurance or reinsurance undertaking is to perform the calculation of the capital add-on in accordance with the specifications set by the supervisory authority and review it at least once a year.

The following examples of performing the calculation were given:

- a request to use the standard formula (SF) or (partial) internal model to identify the risk profile deviation;
- calculation of a capital add-on as a percentage of the premiums of the branch in another Member State;
- evaluation of the calculation criteria for the loss absorbency capacity of deferred taxes.

NCAs proactively monitor the circumstances, that lead to the imposition of the capital add-on. This is particularly relevant for the NCAs that set capital add-ons due to lack of governance.

The survey also asked for an update on the formal policies that have been put in place by NCAs for assessing the potential need for setting and reviewing capital add-ons. In line with last year's survey, the majority of NCAs still have no formal policies in place.

The reasons reported by NCAs for not having such policies are that the legal framework is sufficiently clear as it provides good guidance. Other NCAs stated that their handbooks provide the information needed, or that the supervisory review process (SRP) supports them to set appropriate procedures for setting or reviewing capital add-ons.

In total, only seven NCAs have a formal policy in place. This is one more NCA compared with the previous year's study. This NCA now includes a "lived" policy that according to the NCA resembles a formal one.

The review revealed that of the seven NCAs, that have formal policies in place, only three set capital add-ons. On the other hand, one NCA set a capital add-on but does not have a formal policy.

⁴ For a full description of the processes please refer to the 2018 report.

4. DISCLOSURE

According to Article 51(2) of the Solvency II Directive, EU and EEA Member States may exercise the option to temporarily limit the public disclosure of capital add-ons on an annual basis.

The capital add-ons do not need to be separately disclosed during a transitional period ending no later than 31 December 2020.

At the end of the transitional period, undertakings will be promoting transparency about capital add-ons by publicly disclosing the amount of any capital add-on and giving concise information on how the NCA justified the setting of the capital add-on.

Concerning the public disclosure of the formal policies, as they are usually not in place, the majority of NCAs chose not to disclose them. Indeed, only one NCA (of the seven that have formal policies in place) published its formal policy on its website.

According to Article 31 of the Solvency II Directive and the provisions of related delegated regulations, NCAs that set capital add-ons have to disclose the following:

- Annex XXI – part A, point 23: 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 SCR, with regard to all insurance and reinsurance undertakings supervised under Directive 2009/138/EC;
- Annex XXI – part B, point 8: the criteria used for the application of capital add-ons and the criteria for their calculation and removal.

Out of the eight NCAs that set capital add-ons in 2018, this information was disclosed by all NCAs.

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

5. NUMBER OF CAPITAL ADD-ONS FOR SOLOS

During 2018, eight NCAs set capital add-ons to 21 solo undertakings, out of 2819 (re)insurance undertakings under the Solvency II Directive in the EEA. These include 10 non-life undertakings, eight life undertakings, two reinsurers and one composite undertaking. In 2017, six NCAs had set capital add-ons for a total of 23 solo undertakings.

Hence, although the number of capital add-ons is extremely low and decreased slightly from 2017 to 2018, two more NCAs made use of this tool in 2018.

This might suggest an increase in understanding within the authorities. Indeed, some NCAs mention explicitly, that the processes of setting capital add-ons are part of the ongoing supervisory review processes (SRPs), in which regular capital adequacy assessments are conducted and, when this capital adequacy assessment highlights an issue, a separate SRP on capital add-ons is triggered.

Thus, lessons are learned from this practical implementation, although while there still seems to be some difficulties in setting capital add-ons as also reflected in the low overall use.

As stated by some NCAs, using capital add-ons as a supervisory tool is often still impaired for the following reasons:

- according to the regulatory framework, capital add-ons are to be used as a measure of last resort, are exceptional and transitory and should be considered only when other supervisory measures have failed, are unlikely to succeed or are not feasible;
- a huge amount of data is needed to justify setting a capital add-on and hence the entire process is burdensome and complex;
- the set of capital add-ons could be challenged in court leading to long and complex processes that would not benefit the supervisory process.

Some NCAs believe that in some cases capital add-ons should have been set from a prudential point of view but they were not because of the complexity of the process. In this sense, more practical experience would allow a more efficient use of this tool.

It should also be mentioned in this context, that three NCAs also intended to set a capital add-on, but the possibility of applying it was disregarded for the following reasons:

- an interim standard formula deviation was detected, that proved to be insignificant in the end;
- the undertaking was supposed to have been exposed to additional operational risk on account of a huge potential tax claim, but the tax problem was resolved before the decision about a capital add-on was finalised.

Similarly to previous years, cases of so called “self-imposed” capital add-ons were observed once more in 2018. These are not considered as capital add-ons for the purposes of this report as they were not set by the NCAs. The use of these “self-imposed” capital add-ons is very low: in 2018 there were three cases used by two different Member States, which resembles a decline compared with the previous survey.

These “self-imposed” capital add-ons may evidence two different situations:

- undertakings decide on a voluntary basis to set a capital add-on, following a dialogue with its Supervisory Authority that decided - for the reasons stated above – not to formally set a capital add-on because this is a difficult process and the undertaking accepts that it should hold a specific amount of capital in excess of the SCR;
- undertakings that decide on their own initiative to take a more prudent approach in the calculation of SCR than the one in the Standard Formula.

The first situation should be avoided as capital add-ons refer to specific supervisory measures imposed formally by the supervisory authorities and the procedures for decision to set it should be convergent as far as is possible in order to allow comparison across Member States. Only

capital add-ons set by the NCA change the amount of the SCRs and trigger both disclosure and non-compliance requirements.

For the same reason, also the second situation should be avoided. Undertakings are free to hold additional capital in excess of the regulatory capital requirements up to the amount they consider appropriate. This is indeed the purpose of the assessment of undertakings’ overall solvency needs in the context of ORSA.

Concerning the reasons to set capital add-ons, in 2018 they are once more mainly set under Article 37 (1)(a), i.e. triggered by the deviation of the risk profile from the assumptions underlying the standard formula. In fact, 18 out of 21 capital add-ons relate to this reason. Non-life insurance undertakings continue to have a higher number of capital add-ons, with 10 undertakings but the difference from the number of life undertakings with capital add-ons (eight) is not material.

Only one life undertaking using an internal model has a capital add-on.

In 2018, only two capital add-ons were set as a result of governance deficiencies, for example in respect of the lack of control on expenses of an undertakings’ branch in another Member State. (Table 1.1).

Table 1.1: Capital add-ons at solo level in 2018

Capital add-ons at solo level in 2018					
	Total	Imposed under Article 37(1)(a) ⁵	Imposed under Article 37(1)(b) ⁶	Imposed under Article 37(1)(c) ⁷	Imposed under Article 37(1)(d) ⁸
Total	21	18	1	2	0
Life	8	7	1	0	0
Non-life	10	9	0	1	0
Reinsurance	2	2	0	0	0
Composites	1	0	0	1	0

5 Standard formula significant risk profile deviation.

6 Internal model significant risk profile deviation.

7 Significant system of governance deviation.

8 Significant risk profile deviation following the application of the matching adjustment, volatility adjustment or transitional measures.

The following table provides an overview of the number of capital-add-ons set at solo level in 2018 (under the conditions referred to in Article 37 of the Solvency II Directive) and in which countries they were imposed (Table 1.2).

Table 1.2: Capital add-ons at solo level in 2018 by country

Capital add-ons at solo level in 2018 by country					
	Total capital add-ons	Life undertakings	Non-life undertakings	Reinsurance undertakings	Composites
Total	21	8	10	2	1
Cyprus	1				1
Finland	1		1		
France	2	1	1		
Ireland	1		1		
Italy	1		1		
Norway	2		2		
Spain	1	1			
United Kingdom	12	6	4	2	

6. NUMBER OF CAPITAL ADD-ONS FOR GROUPS

In the EEA insurance market 304 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 2018, only one NCA set group capital add-ons, two for deviations with the risk profile for standard formula users and 1 to a group using an internal model.⁹

⁹ In 2017 the Dutch NCA set two group capital add-ons. These were self-imposed in 2018 and hence removed. This also applies to two group capital add-ons set by the Italian NCA.

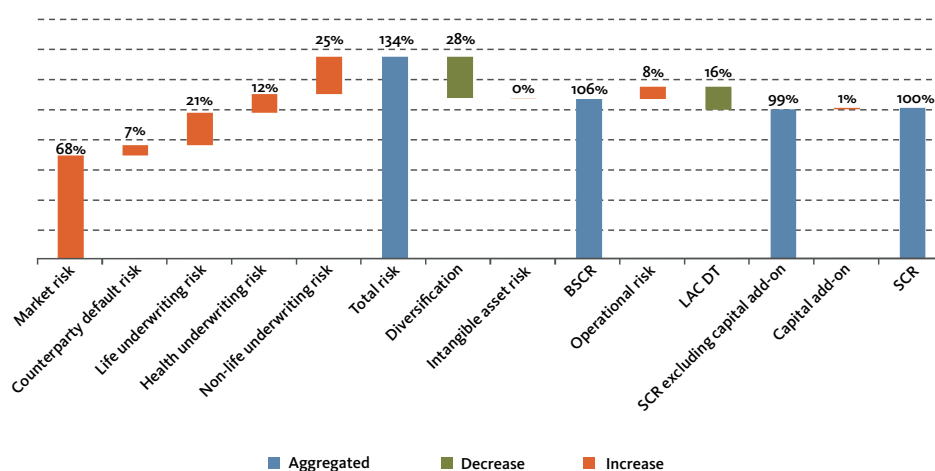
Table 1.3: Capital add-ons at group level in 2018 by country

	Capital add-ons at group level in 2018 by country				
	Number of capital add-ons	Of which imposed under Article 37(1)(a)	Of which imposed under Article 37(1)(b)	Of which imposed under Article 37(1)(c)	Of which imposed under Article 37(1)(d)
United Kingdom	3	2	1	0	0

7. AMOUNT OF CAPITAL ADD-ONS

The amount of capital add-ons imposed on undertakings using the standard formula remains very low overall in 2018 considering the total EEA SCR. It amounts to 1% of the total SCR at EU and EEA levels (Figure 1.1).

Figure 1.1.: Main Components of SCR for all undertakings using the standard formula in 2018¹⁰



However, the amount of capital add-on is not insignificant when considering the amount at individual level (Figure 1.2).

In sum, as of year-end 2018, the weight of the capital add-on increased to 32% (30% in 2017) when looking at the amount of capital add-ons as a percentage of the total SCR for those undertakings using the standard formula with capital add-ons.

The distribution of the capital add-ons as a percentage of the total SCR in 2018 for undertakings that imposed capital add-ons varies substantially once more. In 2018, the largest percentage was 80% (83% in 2017), whereas

the smallest percentage rounded close to 0% (1% in 2017). It should be noted that in all but five cases, if applied, the capital add-on increased the SCR by more than 10% (Figure 1.3).

The cases in which the capital add-ons represent the highest percentage of the SCR correspond to those in which the standard formula does not capture the catastrophe risks that undertakings are exposed to, namely the unsystematic risks stemming from war-related insurance cover and pharmaceutical liability cover. These undertakings are highly specialised 'niche' undertakings, mainly established to cover catastrophe risks.

¹⁰ BSCR – basic solvency capital requirement; LAC DT – loss absorbing capacity of deferred taxes

Figure 1.2.: Main components of SCR for insurers using the standard formula with capital add-on

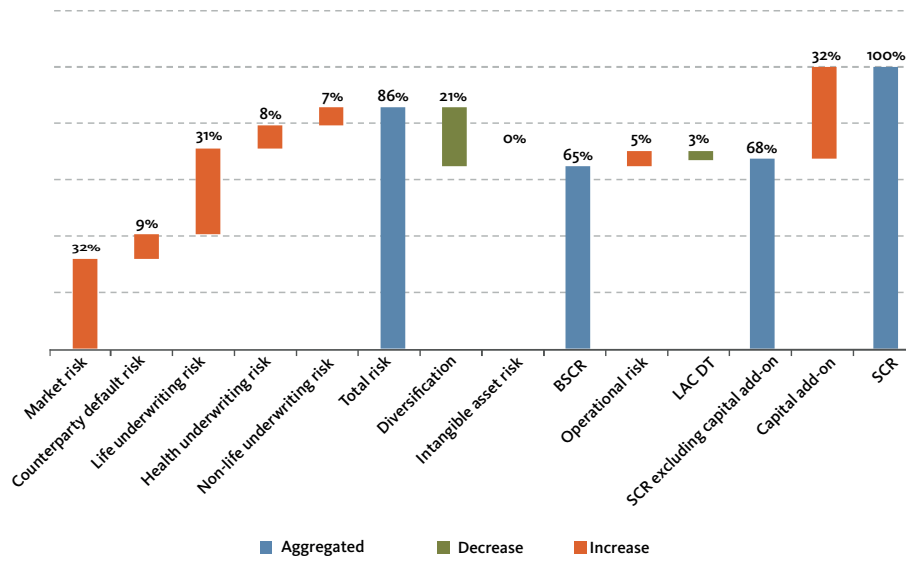
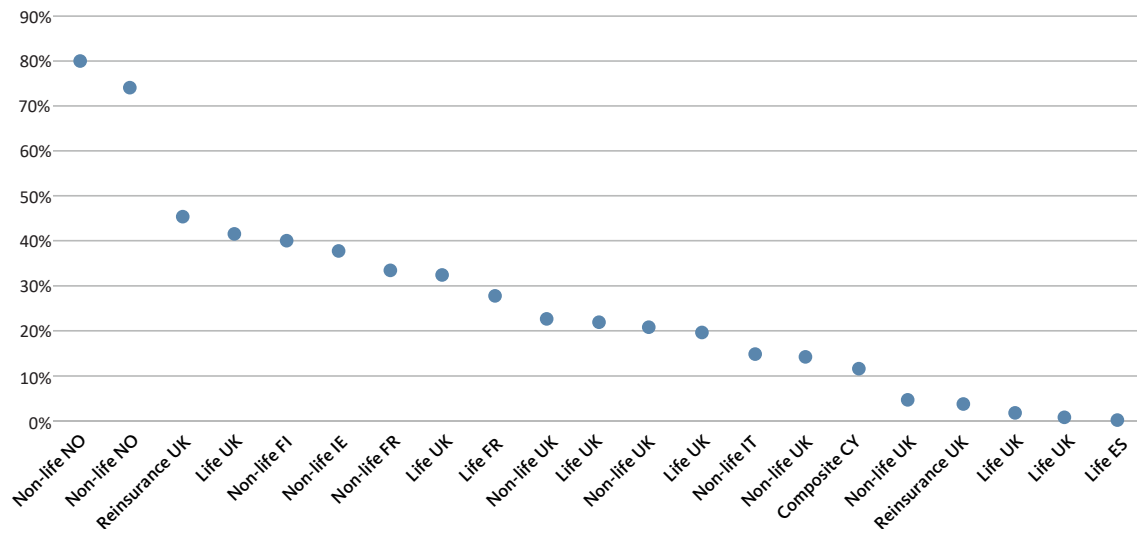


Figure 1.3.: Distribution of the capital add-ons as a percentage of total SCR in 2018 for undertakings with imposed capital add-ons



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