SLAUGHTER AND MAY

The Slaughter and May Podcast

Solvency II podcast – Chapter 7: Own Funds

Robert Chaplin	Hello and welcome to this overview of Own Funds under Solvency II. For more information please see Chapter 7 of our Solvency II App. If you don't already have the App, please email solvency.two@slaughterandmay.com to request access. Own Funds are the capital which a firm holds to ensure it is able to meet its liabilities to policyholders and to remain solvent. All firms will have an individualised Solvency Capital Requirement or SCR and must hold Own Funds at least equal to that SCR. Own Funds are made up of Basic Own Funds plus Ancillary Own Funds. Basic Own Funds are the excess of the firm's assets over its liabilities plus its subordinated liabilities that is liabilities which it may not have to repay. This includes both share and debt capital.
Beth Dobson	All Own Funds are categorised into one of three tiers based on the extent of their permanence and subordination. Ordinary shares are the highest quality of capital known as Unrestricted Tier 1 Capital, since the issuing company has no obligation to repay the shares other than on a winding up, even then, ordinary shareholders are the last to be repaid. Other types of Basic Own Funds include preference shares and subordinated debt. Preference shares and subordinated debt capital are divided into Restricted Tier 1 Capital, Tier 2 Capital and Tier 3 Capital. Each of these tiers can only count towards to the solvency capital requirement up to a certain amount and are therefore types of restricted capital. The key features which are relevant to determining whether preference shares and debt instruments can count towards Own Funds and the tier to which they will be allocated are duration, i.e. when is the first contractual opportunity to repay or redeem the item; the ability to suspend repayment or redemption in the event of non-compliance with the SCR, the ability to cancel or defer distributions in the event of non-compliance with the SCR or MCR and for Restricted Tier 1 items, a principal loss absorbency mechanism involving a write down of the principal amount of the debt or conversion into ordinary shares in response to a significant breach of the SCR.
Robert Chaplin	Moving on to Ancillary Own Funds, these are off balance sheet items which can be called on by the firm to absorb losses if required and accordingly can be counted by the firm as part of Own Funds to meet its SCR. Ancillary Own Funds are always classified in the tier below the one to which they would belong if called up. The main types of Ancillary Own Funds are unpaid share capital, letters of credit and guarantees. In principal, other legally binding commitments received by the firm can count as Ancillary Own Funds, but in practice it has been difficult to get the Regulator to approve other types of Ancillary Own Funds. A point we will come back to.

Beth Dobson	Looking now to a few of the issues which have arisen in practice in the Own Funds area. Under the original Solvency II regime, unlike the Pre-Solvency II rules and the rules for the banking sector, early cash redemption or repayment of Own Fund items for reasons relating to tax or regulatory change was not permitted. This was changed by an amendment to the legislation in July 2019 and early redemption or repayment for cash is now allowed where either there is a change in the regulatory classification of the Own Fund item which would be likely to result in its exclusion from Own Funds, or reclassification as a lower tier of Own Funds or there was a material change in the tax treatment of the Basic Own Fund item. In either case the firm's Own Funds must exceed its SCR by an appropriate margin after the redemption or repayment. Tax has also been involved in another developing area which is the type of principal loss absorbency mechanism included in the terms of debt instruments to allow them to qualify as Tier 1 Capital. The principal loss absorbency mechanism is triggered by significant non-compliance with the SCR which includes where the amount of Own Funds eligible to cover the SCR is equal to or less than 75% of the SCR, and it takes the form of either a write down of the principal amount of the debt or its conversion into ordinary shares. In the UK the first public issuance of Tier 1 Capital under the Solvency II regime was an issuance by RSA in 2017, on which we advised, and which involved a conversion mechanic. Subsequent issuances have varied in whether they use a conversion or write down mechanism but tax changes brought in by HMRC in October 2018, and PRA guidance on the impact of these tax changes on Own Funds have made it more expensive for firms to issue restricted Tier 1 instruments which have a write down principal loss absorbency mechanism.
Robert Chaplin	Group Solvency requirements has probably been the area where there have been the most complications under the new regime. For Own Funds issued by undertakings within a Group to be eligible to count towards the Group Solvency Capital requirement, a number of additional requirements have to be met. Instruments issued by insurance holding companies, for example, must include terms providing that, in the case of winding up proceedings of any insurance undertaking within the Group, payments of amounts due under the instrument are refused until all obligations by that insurance undertaking to its policyholders have been met. The PRA confirmed this expectation in guidance issued in advance of the Solvency II regime coming into force, but it came as a surprise as at the time, this requirement only appears in a cycle to the level 2 delegated regulation and not explicitly in the rules themselves. Another problematic area has been the restrictions on the use of Own Funds issued below holding company level to meet the Group SCR. Under Solvency II preference shares and subordinated debt should be assumed not to be available to cover the Group SCR, unless the Group can demonstrate to the supervisory authority that this assumption is inappropriate in the circumstances. Firms have tended to rely on showing that the Own Funds can be made available to the Group within a specified period of time. The PRA has however now issued

	guidance which restricts the ability of Groups to demonstrate that Own Funds issued below holding company level can be considered as available to meet the Group SCR. The PRA considers that the legal obligations of the issuer to the debtholders make it difficult for the availability test to be met. It suggests that firms may demonstrate availability if each insurance undertaking in the group has a legal right to claim against the issuing entity, if that insurance undertaking is wound up and there is a shortfall for its policyholders. This should also be reflected in the terms and conditions of the debt instruments. The rights of Group undertakings against the issuer must not however affect Group risks and the PRA also expresses the view in its guidance that intra-group guarantees would generally increase such risks. This therefore presents something of a conundrum for firms wanting to count Own Funds issued other than out of TopCo towards the Group SCR. The final area we wanted to touch on in this Podcast is the difficulty with establishing new types of Ancillary Own Funds. We've advised clients on a number of proposed structures to establish Ancillary Own Funds other than via letters of credit or guarantees, but it has been difficult, particularly in the UK, to obtain regulatory approval for these structures. The key issue has tended to be establishing that the items can properly be described as callable on demand which requires there to be no element of contingency relating to the call. The PRA has tended to interpret this as meaning there must be no intervening step once the call has been made. A binding commitment to subscribe for shares, for example, might be viewed as failing this test as the call leads to a subscription for shares rather than directly to the issuance of the shares. Although it is not entirely clear on the face of the legislation itself, in practice, both Tier 2 and Tier 3 items must be callable on demand. The key difference between the two types of Ancillary Own Funds is the tier of two Basic Own Funds into which the AOF converts once called. This brings us to the end of this Podcast but if you have any questions about Own Funds please get in touch with either ourselves or your usual contact at Slaughter and May.

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