To: Karel Van Hulle
Head of Unit Insurance and Pensions
Financial Institutions
Internal Market Directorate-General
European Commission

From: Economics & Finance department

Date: 24 July 2012

Reference: ECO-SLV-12-368

Subject: Insurance Europe letter on the cancellation of dividends for Own Funds

Dear Karel,

Following EIOPA's pre-consultation on the provisions for the automatic cancellation of dividend payments relating to ordinary share capital when the undertakings are in breach of their SCR, Insurance Europe would like to reiterate its concerns on this particular topic, which had been raised among other issues in a previous letter addressed to the Commission, regarding the October 2011 implementing measures (ref.: ECO-SLV-12-171).

In this letter we detail the reasons why Insurance Europe strongly disagrees with the automatic cancellation of dividends when the SCR is breached as a condition of Tier 1 or Tier 2 eligibility. We view it as an unnecessarily drastic action which:

- Is inconsistent with the two level SCR/MCR system of Solvency II and the ladder of supervisory intervention;
- Will result in an increase in capital requirements as the SCR will be viewed as a hard target by financial markets and investors;
- Clashes with some national corporate laws and creates a real risk that ordinary shares would not be classified as Tier 1 or potentially as own funds at all.

We therefore ask for the removal of paragraphs (1h) and (1i) of article 59 COF2 and (1f) of article 61 which introduce the automatic cancellation of dividend. A far better solution is to make use of existing Solvency II structures. If a company breaches the SCR level, discussions on the potential impact on dividend policy should be part of the ladder of intervention dialogue with their supervisor. We would also recognise the need for companies to have internal policies over how they set their dividend policy and the types of circumstances under which their board would need to review and if needed reduce the dividend due to unexpected circumstances. These policies may be reported along with actual outcomes in the company's ORSA.

Inconsistent with two level SCR/MCR and ladder of intervention

Introducing an automatic trigger for the cancellation of dividends is inconsistent with the purpose of the ladder of supervisory intervention. The two level capital structure, SCR and MCR, with a ladder of intervention in between, is a vital part of the framework because it helps cope with the balance sheet volatility that is inherent with the economic and risk based approach upon which Solvency II is based. The SCR is between 222% and 400% of the MCR (based on QIS 5 calibrations) which means that will always be far in excess of the MCR. We welcome the emphasis that the Commission has put on the importance of the two tiers and that breaching the SCR is not intended to signal significant distress but rather to initiate the supervisory dialogue and require the company to demonstrate it has identified how it can rectify the situation within a certain time period.

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If a company falls below its SCR requirement, clearly a reduction or cancellation of the dividends should be one of the actions considered by the Board, however to make this an automatic requirement would raise the importance of the SCR breach to inappropriate levels and override the ladder of intervention.

For example a company with ability to generate retained earnings can rebuild capital relatively quickly and may not need to cancel dividends. Likewise for companies with stop loss systems and protection which can limit the level of losses or who have access to capital at short notice. On the other hand for a company with limited ability to generate additional capital and significant exposure to rapid changes in solvency, cancellation of dividends may be the appropriate decision by the Board. We recognise that at some point if solvency levels are deteriorating management may have to suspend dividend payments but this should not be automatic.

It is also not in line with the Directive which allows insurers 6 months to recover their SCR and significantly longer in the event of an exceptional fall in financial markets. The recovery period has been established to take into account the volatility of the solvency ratio and is part of the two-level MCR/SCR system of Solvency II.

Significantly increases capital requirements

Automatic restrictions of dividends will force the SCR to become the new minimum requirement as investors will punish any company falling below the SCR. This will force companies to hold significant buffers above the SCR to reduce the risk of a breach to very low levels. These buffers will be based on the same risks that drive the SCR for that company. This will increase costs for policyholders and/or result in withdrawal of products creating most volatility in the balance sheet such as those with long term guarantees.

Risks excluding ordinary shares from own funds due to clash with national corporate laws

Requiring as part of Solvency II the automatic cancellation of dividend will raise problems in the application of national corporate laws and/or the companies' own articles. This was also highlighted by EIOPA in their consultation where they stated that:

> "Cancellation would therefore need to be provided for either in national legislation or in the legal or contractual arrangements i.e. the undertaking's statutes or articles of association. …**If this matter is not addressed by one or other of these approaches the ordinary share capital would not meet the criterion. Failure to meet criteria means that the ordinary shares would not be classified as Tier 1 or potentially as own funds at all – i.e. they will not count as Tier 1 own funds"** (text in bold as used by EIOPA).

We remain at your disposal to discuss in more detail this very important issue with potentially important adverse effects on the proper functioning of ladder of intervention, levels of required capital and the costs and provision of products for policyholders.

Regards

Olav Jones