Introducing ancillary own-fund items
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Ancillary own funds (AOFs) are one of the major innovations under Solvency II, being unfunded capital instruments eligible to cover Solvency II capital requirements. They are an alternative to funding available capital with equity or hybrid debt.

Many insurance companies are looking at AOFs as part of their capital management strategies. In particular, they want to see how AOFs can be used as intragroup capital instruments, and how AOFs interact with other key aspects of group capital structure, including risk appetite, cash flows and IFRS reporting.

EY is working with a number of insurers across Europe to optimize their group capital structures and to see how AOFs fit within the overall toolkit. This paper discusses the application and benefits of AOFs common issues that companies face, and how EY can help in dealing with those issues.
Solvency II allows insurers to meet their solvency capital requirement with a range of capital instruments. Own-funds can be composed of equity, hybrid debt and deferred tax assets. The Solvency II regulations also introduce a new unfunded instrument: AOFs. AOFs are committed but unpaid lines of capital. A counterparty (the donor) agrees to increase its investment in an insurer (the recipient). Under Solvency II, capital credit can be obtained for the monetary amount of the AOF once it is approved by the regulator, and does not need to be drawn.

To be eligible as AOF the capital needs to be callable by the recipient on demand with no conditionality attached, such as event triggers based on a certain solvency ratio. The underlying item needs to be eligible basic own-fund capital.

Solvency II splits components of own-funds into three tiers and sets limits as to their composition. Tier 1 capital is the highest ranking with the greatest loss absorbing capacity, such as equity. Tier 2 own-funds are composed of hybrid debt and tier 3 of deferred tax assets. Solvency capital requirements needs to be met with at least 50% tier 1 capital. Tier 3 capital is limited to 15% of the solvency capital requirement. Combined tier 2 and tier 3 capital cannot be used to cover in excess of 50% of the solvency capital requirement. An AOF is notched down one tier from the underlying basic own fund item. For example, contingent equity is tier 2; however, under AOF’s contingent tier 2 becomes tier 3.

There is currently limited precedent for AOFs as these items are a new concept under Solvency II. However, some of the issues insurers face when using external structures include the following:

- The lack of conditionality on the ability to call down the capital may mean an external investor would set the price at the lowest possible level. As a result, the structure may not be cost-effective because of the high option premium.
- Tier-2 AOFs are the most efficient, which implies that the underlying instrument should be equity or hybrid tier 1. Both alternatives give rise to challenges. An equity instrument may lead to a dilution of ownership or control, while the structure of a hybrid is likely to be more complicated.
- Proving willingness and ability to pay may be a higher burden for external investors or more expensive to the AOF recipient if it is collateralized either with cash or a letter of credit (LOC).

What are ancillary own funds?

The majority of AOFs are expected to be internal structures because they present the greatest advantages. However, some of the issues insurers face when using external structures include the following:

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Note: We do not believe an LOC on its own would be eligible as an AOF because it is a form of collateralization rather than a capital instrument.
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Regulatory approvals

The EU implementing regulation (Commission Implementing Regulation 2015/499) stipulates the documentation required as well as the time regulators have to grant approvals.

Regulators have a 30-day application review period to establish whether the application is complete. There is a three-month “normal” approval window from the receipt of a complete application, which stretches to six months in “exceptional” circumstances. An application must include the following documentation:

- Medium-term capital plan
- Assessment of the:
  - Economic substance of the AOF and its loss-absorbing capacity
  - Counterparty’s ability and willingness to pay the call on the AOF
  - Counterparty’s ability and willingness to pay multiple simultaneous calls from other group entities
  - Other Article 308a (Directive 2009/138/EC) approvals pending or foreseen, such as transitional measures or full or partial internal models
- Details of any arrangements in place to offset the counterparty’s credit risk
- Demonstration of a track record of the counterparty meeting its obligations
- Process for monitoring the ongoing credit risk of the counterparty
- Records that the application has received the required governance approvals within the company
- Term sheet for the AOF
- Consideration of disincentives to call
- A legal opinion stating that the AOF is legally binding and enforceable
- An assessment of when the AOF recipient would expect to call the instrument

In addition to this list of documentation some regulators, such as the Central Bank of Ireland have introduced their own contribution agreement templates to be completed as part of the application.

In terms of ongoing monitoring on each reporting date, the board of the recipient will need to confirm to its regulator that there have been no changes in the structure of the agreement or status of the counterparty. At any time, regulators have the power to review the ability and willingness of the counterparty to pay the called-up amount.

The documentation and approval process is less clear for the entity providing the AOF. However, we would anticipate a parallel discussion with the counterparty’s regulator.

Our expectation is that regulators will be cautious given the lack of precedents. They may also be more unwilling to grant approvals where the counterparty is outside of the European Economic Area and in a non-equivalent jurisdiction. There is value in creating precedents and a track record, such as a small test trade as proof of concept.
### Other considerations

- What implications are there of eliminating intragroup transactions within the Solvency II group consolidated solvency ratio.
- What the valuation is of an AOF commitment on the solo balance sheet of an insurance entity.
- How the lack of conditionality is incorporated into group liquidity management and group risk appetite.
- What the duration is of the committed period and interaction with the required minimum tenor of the underlying own-fund instrument.
- AOFs are not included in the definition of basic own-funds and therefore cannot be used to cover the minimum capital requirement.
- Interaction with other credit stakeholders and the disclosure is required, for example, with rating agencies, lending banks and swap counterparties.
- Pricing will not be straightforward and, if the instrument is cross-border, transfer pricing and tax considerations will rise in importance.
- How the AOF interacts with an operating company’s existing capital structure and Solvency II tiering limits, i.e., hybrid tier 1 can only be 20% of total tier 1; tier 2 and tier 3 capital can only be used to cover 50% of the solvency capital requirement; and tier 3 capital can only cover 15% of the solvency capital requirement.
- The AOF, by increasing intercompany financing links, may have implications for the complexity of insurer’s recovery and resolution planning.
- The risk appetite of the recipient may need to be reevaluated given that it has access to these funds on its balance sheet.

### Where can EY help?

We have leading expertise on all aspects of capital optimisation under Solvency II. AOF should be considered along with a range of other options to promote capital efficiency. We have a track record of implementing these solutions including, among others, internal reinsurance, converting operating entities to branches, restructuring asset portfolios and introducing alternative funding structures.

With specific reference to AOF:

- **Preparatory phase:** We can assist with structuring the term sheet for the AOF from a regulatory and tax perspective. This will be more complicated if the underlying instrument is hybrid tier 1 debt rather than equity.
- **Regulatory application:** We can advise you on regulatory analysis and review any documents the group entities prepare before they are shared with the regulators, and assist with capital planning.
- **Other impacts:** In tandem with the preparatory phase and the regulatory application, we can advise on the impact an AOF may have from a tax and disclosure perspective. We anticipate insurers may wish to seek external views on transfer pricing, which is also something we can help document.
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EYG no. EG0287
BMC Agency
BACS 1002647

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