GDV German Insurance Association

POSITION PAPER

Position Paper

of the German Insurance Association (GDV)
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on the deduction of foreseeable dividends
in Solvency II

On the subject of foreseeable dividends in Solvency II, this paper briefly presents the current legal situation, analyses problems with this approach, presents an economically more sensible approach, makes a comparison with the banking sector and outlines a possible way forward.

Deduction of foreseeable dividends from own funds in Pillar 1 of Solvency II

In Solvency II, a large part of Tier 1 own funds is accounted for by the reconciliation reserve. According to Art. 70 of Delegated Regulation (EU) 2015/35, the reconciliation reserve essentially corresponds to the surplus of assets over liabilities, from which some specifically listed items are deducted.

According to Art. 70 (1) (b), the items to be deducted include foreseeable dividends, distributions and fees. Foreseeable dividends therefore directly reduce the eligible own funds.

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However, Delegated Regulation (EU) 2015/35 does not provide a definition of the term "*foreseeable dividends*".

Definition of foreseeable dividends in Pillar 3 of Solvency II

Regarding the quantitative reporting templates (QRTs), Implementing Regulation (EU) 2023/894 of 4 April 2023 explains on page 821, referring to cell R0720/C0060, the term *"Foreseeable dividends, distributions and charges"* as follows:

“These are the dividends, distributions and charges foreseeable by the undertaking. As soon as a dividend is foreseeable it is considered in full in the quarterly reporting. As soon as a dividend is foreseeable, the full amount of dividend must be included in the quarterly reporting at one time, which means that it shall not be added incrementally from quarter to quarter.

A dividend is foreseeable when the payment becomes likely considering the dividend payment history of the company, the business development throughout the year, the reference date of the assessment and, where appropriate, other relevant circumstances.

The dividend shall be reported as foreseeable until it has been approved at the annual general meeting (not until it has been paid).”

Prior to the entry into force of this Implementing Regulation, the term *"Foreseeable dividends, distributions and charges"* was not further specified for the QRTs.

These new requirements mean that dividends to be paid out in the following year must be deducted in full amount as soon as they are likely given the own dividend history, the business development throughout the year, the reference date of the assessment and, where appropriate, other relevant circumstances. This does not rule out subsequent increases and reductions depending on further developments. However, it is not permissible to deliberately spread the full amount over several quarters.

Problems with these requirements / economically sensible approach

As a result of these requirements, there is a one-off decrease in the solvency ratios each year as soon as the foreseeable dividends have to be deducted. In addition, the deduction of a full dividend already in the first quarters of a year does not appear to be appropriate but, on the contrary, misleading from a risk management and an investor’s perspective. Both issues – the one-off-decrease, and the premature indication of a high dividend – are economically questionable and give stakeholders false signals about the current situation of the insurance undertaking as profits reflected by the deducted dividend have not yet been earned.

Moreover, if a deduction already in Q1 is required, there is a double burden in this quarter: both the dividend to be paid this year for the previous year and the dividend to be paid next year for the current year are deducted from the own funds. In addition, 'foreseeable' dividends for which the final decision will be taken more than one year in the future would still be available to cover losses for the whole of the coming one-year period.

In contrast, the definition of foreseeable dividends needs to be based on the undertaking's business model. An incremental approach for the deduction of dividends would be much more economically sensible for most insurance undertakings: As the surplus of assets over liabilities increases – e.g. systematically driven by profitable new business and release of the risk margin or caused by investment returns above risk-free rates or the development of actual underwriting and cost results – in the course of the year, the amount needed for foreseeable future dividend payments also increases. Therefore, an incremental deduction from own funds would correspond to an economic interpretation as the dividend is then deducted in proportion to the actual accrual of underlying profits. Such an economically sensible approach is also supported by a comparison with the banking sector.

However, many insurance business models are seasonally driven or significantly influenced by short term developments (e.g., NatCat risk). As a result, earnings are subject to significant uncertainty until the end of the financial year. In these cases, dividends may not be predictable before the end of the year.

Alternatively, to ensure a level playing field, particularly for capital market-oriented insurance companies, an approach comparable to the banking sector may apply which allows to broadly synchronise the development of foreseeable dividends with the development of underlying profits.

Deduction of foreseeable dividends in the banking sector

The regulation of the banking sector does not provide for a full market value balance sheet as in Solvency II. Accordingly, own funds are not derived directly from the current surplus of assets over liabilities. Instead, profits generated in the current year contribute to regulatory own funds.

According to Art. 26 (1) (c) of the Capital Requirements Regulation (CRR) Regulation (EU) No 575/2013, retained earnings and accumulated other comprehensive income are included in Common Equity Tier 1 under certain conditions. According to Art. 26 (2), interim or year-end profits may only be included in Common Equity Tier 1 capital with prior permission of the competent authority and if any foreseeable charge or dividend has been deducted from the amount of those profits. According to Art. 26 (4), EBA shall draft regulatory technical standards to specify the meaning of *"foreseeable"* in this context.

Commission Delegated Regulation (EU) No 241/2014 provides these regulatory technical standards (RTS) for own funds. Art. 2 sets out in detail what *"foreseeable"* means in relation to foreseeable dividends for the purposes of Art. 26 (2) (b) CRR. Paragraph 4 states:

"Before the management body has formally taken a decision or proposed a decision to the relevant body on the distribution of dividends, the amount of foreseeable dividends to be deducted by institutions from the interim or year-end profits shall equal the amount of interim or year-end profits multiplied by the dividend payout ratio."

This means that in the banking sector, an incremental build-up of foreseeable dividends from quarter to quarter in line with the development of profits is expressly provided for. This seems to be an established, sensible solution. Also, we see no reason for a different and more burdensome solution in the insurance sector.

Possible way forward

In Solvency II, an economically sensible approach should be implemented, too. Moreover, the current detour via an implementing regulation on reporting templates seems not be an adequate approach.

The implementation could be realised by adding a definition of *“foreseeable dividends”* in Art. 1 of Delegated Regulation (EU) 2015/35 as part of the currently pending revision. This definition should specify that the amount of foreseeable dividends to be deducted from own funds may build up gradually and is linked to the development of profits over the year under consideration of the individual business model and dividend policy.

If it should be considered necessary, the term *“dividend policy”* could also be specified. This can either be done with a reference to Art. 2 (6) and (7) of Commission Delegated Regulation (EU) No 241/2014 (the RTS for the banking sector) in the text of the definition of foreseeable dividends or by separate new definitions in Art. 1 of Delegated Regulation (EU) 2015/35.

If Delegated Regulation (EU) 2015/35 is changed in this way, Implementing Regulation (EU) 2023/894 (regarding the QRTs) of course has to be aligned subsequently.

Irrespective of the exact implementation, we believe that a consistent definition of the term "foreseeable dividend" is essential to ensure a level playing field across the European Economic Area.

Berlin, September 24, 2024