

Insurance Europe position on Deduction of Foreseeable Dividends in Solvency II

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Contact person:	Prudential Team	E-mail:	prudential@insuranceeurope.eu
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Introduction

The Implementing Technical Standards (ITS) on supervisory reporting ([Implementing Regulation \(EU\) 2023/894](#)), applicable from Q4 2023, contains a change in the definition of foreseeable dividends creating significant uncertainty in the calculation of own funds and potentially having detrimental, uneconomical impacts on the solvency ratios of insurers.

Importantly, the new definition for “foreseeable dividend” is inconsistent and creates significant uncertainty about the recognition of dividends over time. Consequently, some insurers are now forced to take an uneconomic approach by recognising dividends in full before they are earned, proposed internally, discussed with supervisors, or agreed by shareholders. This results in significant one-off negative impacts on solvency ratios each year when the dividends are recognised, with a subsequent reversal when the profits that are the basis for the dividends are recognised.

The origin of this change is understood to be the response to EIOPA Q&A #1701 which led to a proposal from EIOPA to change the definition in the ITS which was subsequently approved by the Commission. Concerns related to this ITS change were already highlighted by Insurance Europe in the [response to EIOPA’s consultation](#) on the ITS amendments in October 2021. However, these concerns were unheeded by both EIOPA and the Commission. The introduction of a change in Pillar 3 reporting which has a potentially significant impact on the Pillar 1 capital position without an impact assessment, is not the appropriate approach.

Insurance Europe identifies three potential approaches to solve the issue:

- **Clarification from the Commission** that the existing ITS can be interpreted as allowing the accrual of foreseeable dividends on a quarterly basis. This approach should be subsequently **accepted by local supervisors** and reverse the detrimental impact of the new definition.
- **A change to the ITS to revert to the previous wording.**
- **A sensible definition** of foreseeable dividends, which clarifies that economically justified methods considering previously used principles (such as the quarterly accrual method) are acceptable, is **included in the Delegated Regulation (EU) 2015/35**.

This paper briefly presents the current legal situation, analyses problems with the new definition and outlines the above potential approaches to addressing this issue.

Current situation

According to Art 70(1)(b) of the Delegated Regulation, the items to be deducted from the reconciliation reserve (surplus of assets over liabilities) includes foreseeable dividends. Foreseeable dividends, therefore, directly reduce the amount of eligible own funds.

From an economic perspective, retained earnings (including dividends that may be agreed to be paid) qualify as Tier 1 under Article 71 of the Regulation and Articles 93 and 94 of the Directive. These retained earnings can absorb any losses that may subsequently occur. Dividends will cease to be able to absorb these losses as soon as there is a firm commitment to pay out, which is the case at the time of approval by the administrative, management or supervisory body (AMSB).

Some companies have historically recognised dividends when approved under internal governance or accrued the current year's expected dividend on a quarterly basis to reflect that the dividend is being earned on a continual basis during the year.

This approach provides a sensible, but prudent, economic picture of the company's own funds throughout the year. Sensible because an accrual approach provides arguably a "true" economic picture of the own funds. It also serves to minimise SCR ratio volatility as the accrued dividend offsets the increase in own funds due to the earnings. Prudent because from a risk management, ie Solvency II, perspective, the approach reduces own funds which actually remain available for risk absorption until the dividend is approved and/or declared.

Consequences of the changing interpretation of the definition

While the Solvency II Delegated Regulation does not yet provide a definition of the term "foreseeable dividends", a new definition was introduced in the ITS on supervisory reporting, as part of the QRT instructions (ie the term "foreseeable dividends, distributions and charges"). The instructions state that "*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*" (see Annex 1 for full extract).

The new definition states that a foreseeable dividend must be fully considered in the quarterly reporting and cannot be accrued incrementally, before going on to explain that the foreseeable dividend depends on business development throughout the year. This is inconsistent and open to interpretation. For most insurance businesses, an incremental dividend accrual goes hand in hand with the business development over the year, such as when profits emerge or extreme insurance events do not materialise in a given quarter.

Where this change leads to a deduction of a full annual dividend already in the first quarter of a year, this may be misleading and incorrect from a risk management and an investor's perspective. Both issues – the one-off-decrease and the pre-mature indication of a high dividend – are economically questionable and could give stakeholders false signals about the current situation of the insurance undertaking as profits reflected by the deducted dividend have not yet been earned.

For certain business models, it would in practice be gravely damaging to interpret this definition in a way which could push the own funds of a solvent insurer below regulatory thresholds just because the company generates high profits relative to its capital requirement. This could be the case when the company has previously, due to its high profitability, paid a correspondingly high dividend with the result that its solvency would be very negatively impacted if a future dividend were deducted from own funds before the corresponding profits have been recognised in own funds. The more profitable the company in question, the greater the misrepresentation of its true solvency and the greater the probability that it could, in true economic terms, be misrepresented as insolvent.

The text also needs to be interpreted in a context where many insurance business models are seasonally driven or significantly influenced by short term developments, such as natural catastrophes. As a result, earnings are subject to significant uncertainty until the financial year-end, making it difficult to predict the full amount of dividends in advance.

Furthermore, the new approach deviates from the [EIOPA guidelines on classification on the own funds](#), where foreseeable dividends are recognised when the proposal is “declared or approved by the administrative, management or supervisory body (AMSB)”. This deviation was previously highlighted in Insurance Europe’s [response to EIOPA’s consultation](#) on this change in October 2021.

Potential ways forward

Insurance Europe identifies three potential approaches to solve the issue:

- **Clarification from the Commission** that the existing ITS can be interpreted as allowing the accrual of foreseeable dividends on a quarterly basis. This approach should be subsequently **accepted by local supervisors** and reverse the detrimental impact of the new definition.
- **A change to the ITS to revert to the previous wording.**
- **A sensible definition** of foreseeable dividends, which clarifies that economically justified methods considering previously used principles (such as the quarterly accrual method) are acceptable, is **included in the Delegated Regulation (EU) 2015/35**.

The definition of foreseeable dividends should be aligned with the undertaking’s business model for an appropriate implementation within Solvency II. An incremental approach to the deduction of dividends is more economically sensible for most insurance undertakings. Over the course of the year, as the surplus of assets over liabilities increases – eg 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 – the amount needed for foreseeable dividend payments would also rise. This method allows dividends to be recognised alongside the accrual of underlying profits, offering a more economic reflection.

While the ITS change has created uncertainty, such an approach was clearly considered appropriate prior to the recent ITS change and is further supported by a comparison with the banking sector (see Annex 2 for more details). To ensure a level playing field, particularly for capital market-oriented insurance companies, an approach comparable to the banking sector should be considered. Such an approach would allow to broadly synchronise the development of foreseeable dividends with the development of underlying profits.

This could easily be implemented by either clarification from the Commission on the intention of the current wording or preferably reverting to the previous wording.

Alternatively, a definition of “foreseeable dividends” could be added 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 Solvency II Delegated Regulation is changed in this way, Implementing Regulation (EU) 2023/894 (regarding the QRTs) of course has to be subsequently aligned.

Annex 1 - QRT S.23.01 – Foreseeable dividends, distributions and charges

[Implementing Regulation \(EU\) 2023/894](#) of 4 April 2023 (page 821), referring to cell R0720/C0060 of QRT S.23.01, explains 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)."

Annex 2 - 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), the European Banking Authority shall draft regulatory technical standards (RTS) to specify the meaning of "foreseeable" in this context.

Commission Delegated Regulation (EU) No 241/2014 provides these 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.

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers pay out over €1 000bn annually — or €2.8bn a day — in claims, directly employ more than 920 000 people and invest over €10.6trn in the economy.