EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Overview

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises EIOPA's proposals in this consultation paper. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and insurance guarantee schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**)[2]. This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of areas as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own Funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

The remainder of this briefing note provides a summary of EIOPA's proposals in the CP under each of these areas.

Milliman is producing separate briefing notes covering each of these areas in more detail.

In Ireland, the Central Bank of Ireland (**CBI**) has contacted several undertakings with information requests for completion by 6 December 2019. The information request is set out on the EIOPA website[3] and is being carried out for a sample of undertakings throughout Europe[4] (**the information request**). Two information requests are expected in relation to EIOPA's proposals. This is the first and covers the impact of the proposed changes to the following:

- Volatility adjustment
- Risk free rates for CZK, HUF, PLN, RON, CHF and USD
- Technical provisions, in particular contract boundaries, Economic Scenario Generators (**ESGs**), dynamic policyholder behaviour, future management actions and expense assumptions
- Calculation of standard formula SCR in particular equity risk, interest rate risk, property risk, non-life catastrophe risk and risk mitigating techniques
- Group supervision

A survey on costs and benefits of the proposed changes is also being carried out as part of the information request. This covers the following topics:

- Recovery and risk management planning
- Calculation of technical provisions
- Calculation of SCR and MCR
- Own Risk and Solvency Assessment (**ORSA**)
- Reporting and disclosure

A second information request is expected in March 2020 for a more holistic impact assessment.

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive
[2] EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II
[3] EIOPA's December 2019 information request on the 2020 Solvency II review
[4] We believe EIOPA has asked each National Supervisor to survey 50% of the industry.

LTG and Equity Risk Measures

Under this heading EIOPA has considered the following topics:

- Extrapolation of risk-free interest rates
- Matching Adjustment (**MA**)
- Volatility Adjustment (**VA**)
- Transitional Measures
- Equity risk measures
- Extension of the recovery period in the case of non-compliance with the SCR
- Other areas including disclosure of LTG measures and risk management provisions in relation to LTG measures

EIOPA is proposing the following key changes:

- Extending the Last Liquid Point (**LLP**) for the Euro.
- New asset eligibility criteria to apply to restructured assets in MA portfolios, and allowing for diversification between the risks in MA portfolios, and other business in the calculation of the standard formula SCR.
- Possible changes to the design of the VA and whether it should be subject to supervisory approval. The information request includes a template assessing the impact of two potential approaches to the calculation of the VA on the solvency position. EIOPA has not yet decided on its recommendation here.
- Possible requirements in relation to dynamic modelling of the VA in internal models, depending on the design chosen for the VA.
- Minimum disclosure requirements in relation to LTG measures and transitional measures in the public Solvency and Financial Condition Report (**SFCR**) including a sensitivity analysis to a fixed downward shift of 100 basis points in the Ultimate Forward Rates (**UFR**s).
- Restricting the ability to newly apply for transitional measures on the use of transitional measures on risk free rates and technical provisions.
- Long term equity eligibility criteria.
- Duration based equity risk sub module to be phased out.
- Supervisors to be given the power to limit capital distributions in exceptional circumstances where undertakings do not meet the SCR without applying the LTG and transitional measures.

Technical Provisions

Under the heading Technical Provisions, EIOPA has several proposals including:

- Allowing for an undertaking's specific new business plans when projecting expenses. As EIOPA notes in the CP, this could be considered as departing from transfer value. EIOPA has asked stakeholders if the proposed definition may introduce barriers to entry for new undertakings.
- In relation to contract boundaries, EIOPA is proposing clarifying the wording on obligations related to paid-in premiums which should be considered to belong to the contract after the date when the undertaking can unilaterally cancel the contract.
- Amending the definition of Expected Profit in Future Premiums (**EPIFP**) to include all future losses, the impact of reinsurance and future profits in fees for servicing and managing funds for unit linked products.
- Adding a definition of future management actions to the Delegated Regulation.

Note that EIOPA considered several options for changes to the risk margin but has concluded that it is proposing no changes. It has asked stakeholders for feedback in relation to the possible allowance for the VA or MA in the risk margin calculation and in relation to the use of a fixed cost of capital rate.

We note that EIOPA is not yet suggesting changes in relation to ESGs or dynamic policyholder behaviour but it has asked for information on the use of these in the information request. Therefore it is possible that changes to these may be considered in its final opinion in June 2020. EIOPA is also assessing the impact of changes to the derivation of risk free rates in certain currencies.

Own Funds

EIOPA considered the differences in limits and tiering between the insurance and banking frameworks (Solvency II and CRD IV) and deemed them to be justifiable. There are no changes proposed to the tiering structure nor limits. EIOPA also proposes no change to the attribution of EPIFP to Tier 1.

EIOPA is proposing that the group supervisor should assess the level of double leverage (when a parent entity provides Tier 1 capital support to a subsidiary which is financed by externally issued parental non Tier 1 capital) and take actions when double leverage is excessive (when the ratio of a parent undertaking's Tier 1 investment in subsidiaries to its own Tier 1 items is over 100%).

SCR

Under the heading SCR, EIOPA has several proposals, including:

- Update calibration of interest rate risk sub-module - EIOPA "strongly advises" changing the capital requirements calculation for interest rate risk. It is proposing new shock values with both multiplicative and additive parameters varying by maturity. This is consistent with EIOPA's advice to the EC under the 2018 interim review[5] that the EC chose not to implement at that time.
- EIOPA is proposing optional simplified calculations in the counterparty default risk module for the risk mitigating effect of derivatives, reinsurance, special purpose vehicles and insurance securitisations.
- Methods for recognising risk mitigation techniques for non-life underwriting risks.

EIOPA has considered the following SCR topics and decided not to propose changes. It has asked for stakeholder feedback on some of these topics.

- Spread risk – EIOPA has considered but is not proposing any changes to the spread risk sub-module.
- Property risk – EIOPA has asked for any data sources that might help to better calibrate property risk.
- Correlations – EIOPA is asking for quantitative evidence of any views that correlations should be changed within market risk or between lapse risk and market risk.
- Underwriting risks – EIOPA has considered but is not proposing any changes to the calibration of the underwriting risk stress factors.
- Non-life catastrophe risks – EIOPA discusses non-life catastrophe risks but makes no proposals at this time. In the information request EIOPA is looking for information on non-life catastrophe risk exposures.
- Reducing reliance on external credit ratings – EIOPA is proposing to open an analysis table to investigate how new alternative credit assessment methods could be used.
- Transitional on government bonds – EIOPA advises not to extend the transitional period for exposures to member states' central governments or central banks denominated in the domestic currency of another member state.

In the information request, EIOPA is assessing the impact of changes to the interest rate risk sub-module and looking for information in relation to equity risk, property risk, non-life catastrophe risks and risk mitigating techniques.

MCR

EIOPA is proposing changes to the risk factors used to calculate the non-life components of the MCR calculation.

EIOPA has also clarified the wording in relation to non-compliance with the MCR.

Reporting and Disclosure

EIOPA is proposing changes to the structure and the content of the Regular Supervisory Report (**RSR**). Annex 7.1 of the CP sets out the proposed revised contents.

EIOPA has also proposed some changes to the group reporting templates. Note that further changes to reporting and disclosure were considered in the first wave of consultation papers from EIOPA which are discussed in a separate Milliman briefing note.

EIOPA is proposing changes to the group SFCR similar to those for the solo SFCR (covered in the first wave of consultation papers and a separate Milliman briefing note) including the requirement for external audit of the SFCR. EIOPA is proposing that external audit should cover the Solvency II balance sheet at a minimum, with the option for each member state's supervisor to also include the SCR and eligible own funds. EIOPA is also proposing extending the deadline for the group SFCR by 2 weeks from 20 to 22 weeks.

Proportionality

EIOPA has considered proportionality in relation to technical provisions and is not currently proposing any changes. It has asked for "concrete proposals" from stakeholders on what changes might be necessary to technical provisions to improve the proportionality of the requirements.

EIOPA is proposing proportionality related changes in the areas set out below.

THRESHOLDS FOR EXCLUSION FROM SOLVENCY II

EIOPA is proposing an increase in the thresholds for exclusion from Solvency II. The technical provisions threshold is proposed to increase from €25 million to €50 million. It is proposing to allow member states the option to set a premium income threshold higher than the current €5 million up to a maximum of €25 million.

SCR

EIOPA is considering introducing further simplifications to the standard formula calculations of capital requirements for immaterial risks. It is asking stakeholders for their preference for options on simplifications between:

[5] EIOPA's 2018 advice to the European Commission on specific items in the Solvency II Delegated Regulation

- Introducing a new set of simplification calculations of capital requirements for immaterial risks, and
- Introducing an integrated simplified calculation of capital requirements for immaterial risks.

KEY FUNCTIONS

EIOPA is proposing that the following situations are permitted if justified under proportionality:

- A person may be responsible for more than one key function
- A person may be responsible for operational functions and a key function (except the audit function)
- A person may be responsible for a key function and be a board member

THE BOARD

EIOPA proposes that undertakings regularly assess the composition and effectiveness of the Board.

ORSA

EIOPA is proposing that the assessment of deviations of the risk profile of the undertaking from the assumptions underlying the standard formula does not need to be included in the annual ORSA, but can be provided every two years and following any significant change in the risk profile.

It is also proposing that the complexity of stress tests and scenario analysis can take into account proportionality.

As noted below, EIOPA is also proposing to expand the ORSA to include the macroprudential perspective.

WRITTEN POLICIES

EIOPA is proposing relaxing the requirement to review written policies annually and allowing a less frequent review up to every three years taking into account proportionality.

REMUNERATION

EIOPA is proposing limiting the current requirement to defer a substantial portion of variable remuneration taking into account the size of the undertaking and of the variable remuneration. EIOPA notes that it is in the process of finalising an opinion on the supervision of remuneration principles in the insurance and reinsurance sector following a consultation earlier this year[6].

Group Supervision

EIOPA is proposing the following changes in relation to group supervision:

- Changes to the calculation of group solvency
- Clarification of the requirements of the system of governance at group level
- Definition of groups and the scope of application of group supervision
- Supervision of intragroup transactions and risk concentration
- Supervisory powers where the parent is headquartered in a non-equivalent third country
- Supervisory powers over insurance holding companies and mixed financial holding companies

The information request includes an assessment of the impact on solvency of changes proposed for group supervision.

FoS and FoE

EIOPA is proposing changes in relation to insurance companies operating cross-border including:

- A requirement to declare during the authorisation process if a formal or informal request for authorisation in another country was rejected or withdrawn and the reasons for this
- Information exchange between home and host supervisors in case of material changes in the FoS activities
- Enhanced role for EIOPA in complex cross-border cases where supervisors fail to reach a common view in the collaboration platform including the power to make recommendations to the supervisor concerned and to make these public if they are not adopted
- Cooperation between home and host supervisors during ongoing supervision to ensure the home supervisor understands whether the undertaking has a clear understanding of the risks in host territories covering at least:
  - System of governance
  - Outsourcing arrangements and distribution partners
  - Business strategy and claims handling
  - Consumer protection
- Host supervisors to be given the power to request information with regard to the business of undertakings operating in that member state from the home supervisor or the undertaking in a reasonable timeframe and in the official language of that member state.

These proposals are to ensure that supervisory powers are sufficient to prevent failures of insurance companies operating cross-border.

[6] EIOPA consultation paper on the supervision of remuneration principles in the insurance and reinsurance sector

Macroprudential policy

The EC asked EIOPA to advise on how to improve the following areas:

- ORSA
- Systemic risk management plans
- Liquidity risk management planning and reporting
- Prudent person principle

EIOPA is proposing the following:

- Supervisors should be given the power to trigger, set, calculate and remove a capital surcharge to address entity-, activity- or behaviour-based sources of systemic risk. EIOPA is proposing to draft guidelines to ensure consistency and is asking for stakeholder feedback on the principles to be considered.
- Supervisors should be given the power to define "soft" thresholds[7] at market levels to identify excessive concentrations and to intervene where there is a risk to financial stability. EIOPA is proposing to draft guidelines to ensure consistency and is asking for stakeholder feedback on the factors to be considered when setting soft thresholds at market-wide level.
- Expanding the ORSA to include the macroprudential perspective. Undertakings should include macroprudential considerations and potential sources of systemic risk in the ORSA. Supervisors should use ORSAs to aggregate information on sources of systemic risk.
- Expansion of the prudent person principle to take into account macroprudential concerns (such as risk related to the credit cycle and economic downturn).
- Supervisors should be given the power to require systemic risk management plans from certain undertakings[8] in which undertakings present all applicable measures they intend to undertake to address the systemic risk the undertaking may pose in the financial system.
- Liquidity risk management plans required with the possibility given to supervisors to waive this for certain undertakings.
- Supervisors to be given the power to impose a temporary freeze on redemption rights of policyholders of undertakings affected by a significant liquidity risk. EIOPA states this should be applied as a last resort measure in exceptional circumstances and EIOPA should issue guidelines to further specify "exceptional circumstances".

In addition to the above proposed tools and measures, EIOPA states that it is working on other improvements to the reporting framework from macroprudential point of view. In particular:

- EIOPA sees a need to enhance the reporting framework with the aim of detecting potential market-wide liquidity stresses
- EIOPA mentions the risk of market-wide under-reserving as another area where enhancements to reporting are needed.

Recovery and Resolution

EIOPA is proposing that a minimum harmonised recovery and resolution framework should be established across the EU. It sets out a range of proposals in the areas set out below.

RECOVERY MEASURES

- A requirement for pre-emptive recovery plans to be developed and maintained by undertakings (covering a very significant share of each national market)
- Supervisors to be given early intervention powers as follows:
  - Additional or more frequent reporting
  - Require the Board to implement measures set out in the pre-emptive recovery plan within a specific timeframe
  - Require the undertaking to limit variable remuneration and bonuses
  - Suspend or limit the right of policyholders to surrender on a temporary basis (for life undertakings)

RESOLUTION MEASURES

- Member states should establish an administrative resolution authority for the resolution of undertakings
- Resolution authorities should consider the following objectives:
  - To protect policyholders
  - To maintain financial stability
  - To ensure continuity of functions
  - To protect public funds
- Resolution authorities should develop and maintain resolution plans and conduct resolvability assessments in a pre-emptive manner for undertakings covering a significant share of the national market

[7] EIOPA explains "soft" thresholds as a monitoring tool that can be exceeded but would raise awareness of supervisors who could take action as appropriate. These are less intrusive than "hard" thresholds which are regulatory limits that cannot be breached.

[8] Systemically important undertakings, as well as to those that are involved in certain activities or products with greater potential to pose systemic risk

- Grant resolution authorities with a set of harmonised resolution powers (EIOPA sets out a minimum list of powers that should be included)
- Supervisors should establish cross-border cooperation and coordination arrangements between resolution authorities for crisis situations.

TRIGGER FRAMEWORK

- Supervisors to be given the power to set judgement-based early intervention triggers
- EIOPA is of the view that non-compliance with the SCR is an appropriate trigger for entry into recovery
- Judgment-based triggers for entry into resolution should be introduced and should include:
  - Undertaking is no longer viable
  - Recovery measures have been exhausted
  - Resolution action is necessary in the public interest

The information request includes a survey on costs and benefits which includes a section on recovery and risk management planning.

Fit and Proper requirements

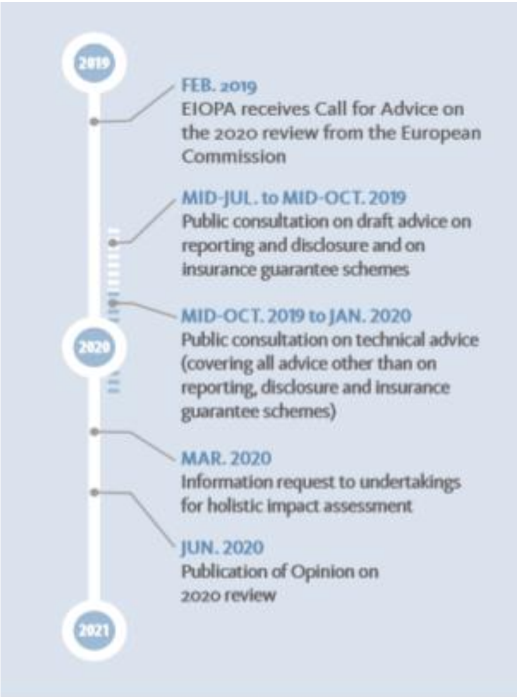
EIOPA states that a number of cross-border cases indicate a lack of harmonisation across the EEA in the assessment of fit and proper requirements of Board members and qualifying shareholders.

EIOPA is proposing the following:

- Clarifying ongoing assessment of the Board and ongoing assessment of qualifying shareholders
- Allowing EIOPA to assist in complex cross-border cases where a common view between supervisors is not reached.

Summary

EIOPA's timeline for the 2020 review of Solvency II is shown below.



Source: EIOPA Fact sheet on the 2020 review of Solvency II

There is a lot of information for undertakings to digest in a short period of time in order to provide feedback on the CP. There is also a lot of work to do for undertakings that have been asked to respond to the information request.

CONTACT

DUBLIN

Aisling Barrett
aisling.barrett@milliman.com

Eoin King
eoin.king@milliman.com

Follow our 'Milliman Ireland' page:
https://www.linkedin.com/company/milliman-ireland