

## REQUEST TO EIOPA FOR TECHNICAL ADVICE ON THE REVIEW OF THE SOLVENCY II DIRECTIVE

### (DIRECTIVE 2009/138/EC)

With this mandate to EIOPA, the Commission seeks EIOPA's Technical Advice on:

- long-term guarantees (LTG) measures and measures on equity risk (**Article 77f**);
- specific methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement standard formula (**Article 111(3)**);
- rules and supervisory authorities' practices on the application of **article 129** (calculation of the Minimum Capital Requirement);
- the supervision of insurance and reinsurance undertakings in a group (**Article 242(2)**);
- other items related to the supervision of insurance and reinsurance undertakings.

The mandate follows the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "**290 Communication**")<sup>1</sup>, the Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority (**the EIOPA Regulation**)<sup>2</sup>, the Framework Agreement on Relations between the European Parliament and the European Commission (the "**Framework Agreement**")<sup>3</sup> and the inter-institutional agreement on better law-making<sup>4</sup>.

This technical advice shall be delivered by 30 June 2020.

## 1. Context

### 1.1. Scope

On 1 January 2016, Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (hereafter "Solvency II Directive") entered into application.

This Directive provides that certain areas of the framework should be reviewed by the Commission at the latest by 1 January 2021, namely:

- long term guarantees (hereafter "LTG") measures and measures on equity risk<sup>5,6</sup>;
- methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement standard formula<sup>7</sup>;

<sup>1</sup> Communication of 9.12.2009. COM(2009) 673 final.

<sup>2</sup> Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), OJ L 331, 15.12.2010, p. 48–83.

<sup>3</sup> The Framework Agreement on relations between the European Parliament and the European Commission, OJ L304/47, 20.11.2010, p.47.

<sup>4</sup> Inter-institutional agreement between the European Parliament, the Council of the European Union and the European Commission of 13 April 2016 on Better Law-Making, OJ L 123, 12.5.2016, p.1.

<sup>5</sup> See Article 77f of the Solvency II Directive.

<sup>6</sup> The LTG measures are the extrapolation of risk-free interest rates, the matching adjustment, the volatility adjustment, the extension of the recovery period in case of non-compliance with the Solvency Capital Requirement, the transitional measure on the risk-free interest rates and the transitional measure on technical provisions. The equity risk measures are the application of a symmetric adjustment mechanism to the equity risk sub-module and the duration-based equity risk sub-module.

<sup>7</sup> See Article 111(3) of the Solvency II Directive.

- Member States' rules and supervisory authorities' practices regarding the calculation of the Minimum Capital Requirement<sup>8</sup>;
- group supervision and capital management within a group of insurance or reinsurance undertakings<sup>9</sup>.

In addition to the above-mentioned topics, the Commission services identified other areas that deserve further reflection. They are further specified in the next sections.

Apart from the Solvency II Directive, the scope of the review may extend to Delegated and Implementing Regulations as appropriate.

## **1.2. Principles that EIOPA should take into account**

In providing its technical advice, EIOPA is invited to take account of the following principles:

- The provided technical advice should contain a detailed holistic impact assessment of all relevant effects, qualitative and quantitative, on European level and on each Member State; the detailed impact assessment should be presented in easily understandable language respecting current legal terminology at European level.
- It should respect the requirements of the EIOPA Regulation and is invited to widely consult market participants in an open and transparent manner. EIOPA should provide advice which takes account of different opinions expressed by the market participants during the consultation and should provide a feedback statement on the consultation justifying its choice vis-à-vis the main arguments raised during the consultation.
- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objectives of the Solvency II Directive and provide for the proportionate application of the Solvency II Directive, in particular in relation to small insurance undertakings, and avoid creating excessive administrative or procedural burdens for (re)insurers.
- EIOPA will determine its own working methods depending on the content of the issues being dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out.
- EIOPA should justify its advice by identifying, where relevant, a range of technical options and by undertaking evidence-based assessment of the costs and benefits of each. The results of this assessment should be submitted alongside the advice to the Commission. Where administrative burdens and compliance costs on the side of the industry could be significant, EIOPA should where possible quantify these costs.
- EIOPA should provide sufficient factual data backing the analyses gathered during its assessment. To meet the objectives of this mandate, it is important that the presentation of the advice produced by EIOPA makes maximum use of the data gathered and enables all stakeholders to understand the overall impact of the options presented by EIOPA. The scope of this call for advice may require several data requests to National Supervisory Authorities and industry stakeholders.
- EIOPA should provide comprehensive technical analysis on the subject matters described below covered by relevant provisions of the Solvency II Directive and the related provision of the delegated acts.
- The technical advice given by EIOPA should not take the form of a legal text.

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<sup>8</sup> See Article 129(5) of the Solvency II Directive.

<sup>9</sup> See Article 242(2) of the Solvency II Directive.

- EIOPA should address to the Commission any question it might have concerning the clarification of the text of the legislative act, which it should consider of relevance to the preparation of its technical advice.

## **2. Procedure**

The Commission requests the technical advice of EIOPA in preparation of the review of the Solvency II Directive on the questions referred to in section 4 of this formal mandate. Furthermore, EIOPA is requested to conduct an assessment of the quantitative impact of potential alternative approaches for the matching adjustment and the volatility adjustment as described in section 4.2.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate will not prejudice the Commission's final decision in any way. In accordance with the established practice, the Commission may continue to consult experts appointed by the Member States to prepare review of the Solvency II Directive.

The Commission has duly informed the European Parliament and the Council about the final version of this mandate.

## **3. EIOPA is invited to provide technical information on the following items:**

### **3.1. Extrapolation of the Risk-Free Interest Rate term structure (Art. 77a)**

In order to ensure that the rules applicable to the last liquid point in the Solvency II Risk-free interest rate term structure ensure its stability in different market situations, including market crisis situations and periods of increasing interest rates, EIOPA is asked to provide evidence, for all currencies of the Union, on criteria to determine the last liquid point. As a minimum, evidence should be provided on the value of the last liquid point in accordance with the following criteria:

- the depth, liquidity and transparency of swap and bond markets in a currency;
- the ability of insurance and reinsurance undertakings to match with bonds the cash-flows which are discounted with non-extrapolated interest rates in a currency;
- for all relevant maturities, the cumulative value of bonds with maturities larger than or equal to the relevant maturity in relation to the volume of bonds in the market.

This evidence should be provided at the very least for the time period 2016-2018, and ideally several years further in the past, including to the extent possible periods of market stresses and increased interest rates, and be accompanied by a variation analysis of those parameters relevant for determining the last liquid point per currency.

If EIOPA's analysis suggests inappropriateness of any currently implemented last liquid points, EIOPA is requested to provide a comprehensive impact assessment of potential modifications to these last liquid points on volatility of insurance and reinsurance undertakings' own funds and solvency coverage ratio, as well as on financial stability. This impact assessment should be provided in a sufficient level of detail, as a minimum on country level.

### **3.2. Matching adjustment (Art. 77b, 77c) and volatility adjustment (Art. 77d)**

EIOPA is asked to assess the efficient functioning of the volatility adjustment and the matching adjustment as mechanisms to prevent pro-cyclical behaviour on financial markets and to mitigate the effect of exaggerations of bond spreads, in view of a level playing field in the EU and policyholder protection.

The Commission services are envisaging to assess possible approaches to review the design, calibration and functioning of the adjustments, whilst not precluding the possibility of a single adjustment mechanism.

*a) Volatility adjustment*

EIOPA is asked to provide an assessment of the quantitative impact on the calculation of the best estimate and the solvency position of insurance undertakings of the following approaches for the calculation/application of the volatility adjustment:

- Approach 1: the application of an adjustment that takes into account the illiquidity features and/or duration of insurers' liabilities, while maintaining the current concept of representative portfolios. That adjustment may rely on different "application ratios";
- Approach 2: the application of an adjustment that takes into account the weights of own assets holdings of each insurer; that adjustment may rely on different "application ratios" depending on the level of cash-flow matching of insurance liabilities portfolios. When applying this approach, EIOPA should specify the assumptions regarding diversification benefits in the calculation of the Solvency Capital Requirement.

In addition, EIOPA is asked to review the functioning of the increased volatility adjustment per country given its purpose and suggest amendments to the measure where necessary.

*b) Matching adjustment*

EIOPA is asked to provide an assessment of the quantitative impact on the calculation of the best estimate and the solvency position of insurance undertakings of the following approaches for the calculation/application of the matching adjustment:

- Approach 1: a change in the current assumption of no diversification benefits (including full diversification); where EIOPA assesses assumptions of partial diversification, it should provide criteria and methods to determine the appropriate level of diversification;
- Approach 2: a review of the criteria for eligible assets for the use of the matching adjustment, including their cash-flow characteristics and credit quality.

### **3.3. Transitional measures**

Title VI Chapter I of the Solvency II Directive lays down a number of transitional provisions. EIOPA is asked to assess the ongoing appropriateness of the transitional provisions in terms of policyholder protection and level-playing field. This assessment should, where applicable, also assess whether the ongoing possibility for companies to newly apply for the transitional measures should continue. EIOPA may prioritise its work on the different transitional measures, provided that the advice states the reason for doing so. However, EIOPA's assessment should cover at least the transitional measures referred to in Articles 308b (12) and (13), Article 308c and Article 308d of the Solvency II Directive.

### **3.4. Risk margin**

EIOPA is asked to assess the appropriateness of the design of the risk margin, without challenging the approach based on the cost-of-capital. In particular, EIOPA should assess the ongoing appropriateness of:

- the design of the risk margin, in light of the work currently undertaken by EIOPA on the transfer value of liabilities, in the context of the Commission’s Call for information<sup>10</sup>;
- the assumptions regarding the asset mix of the receiving undertaking, in particular with regard to the assumption of risk-free investments. This assessment should take into account the potential interactions between the recognition of market risk and the use of the volatility adjustment and the matching adjustment in the risk margin calculation;
- the use of a fixed cost-of-capital rate for all insurance and reinsurance undertakings;
- the assumptions used to derive the cost of capital rate, including the absence of leverage and the derivation of the equity risk premium.

### **3.5. Capital Markets Union aspects**

EIOPA is asked to continue its analysis on the treatment of long-term investments under Solvency II. In particular, EIOPA is asked to assess whether the methods, assumptions and standard parameters underlying the calculation of the market risk module with the standard formula appropriately reflect the long-term nature of the insurance business, in particular equity risk and spread risk. To this end, EIOPA is asked to:

- identify the characteristics of insurance business and liabilities that enable insurers to hold their investments for the long term; and
- where appropriate, advise on revised methods, assumptions and standard parameters for the purpose of calculating the market risk module, reflecting insurers’ behaviour as long-term investors.

With regard to equity, EIOPA is also asked to conduct a comprehensive review of the equity risk sub-module, and in particular to assess the appropriateness of the design and calibration of the duration-based equity risk sub-module, of strategic equity investments, of long-term equity investments and of the symmetric adjustment.

As regards the correlation matrices, EIOPA is asked to assess the appropriateness of the structure of the (sub-) modules and the calibration of correlation parameters used in the Solvency Capital Requirement standard formula. Any advice to change the calibrations should be based on quantitative models and evidence. In particular, the correlations within market risk, as well as the correlation between lapse risk and the different market risks should take into account potential advice on market risk recalibrations.

### **3.6. Dynamic modelling of the Volatility adjustment**

EIOPA is asked to assess whether the modelling of the dynamic volatility adjustment by internal model users sets disincentives for insurance and reinsurance undertakings’ investment and risk management strategies, and whether the existence of diverging practices in this regard can be detrimental to the level playing field. In this context, EIOPA is asked to assess the appropriateness of this dynamic modelling in internal models in light of the assumptions underlying the volatility adjustment. In case that EIOPA advises to maintain this dynamic modelling in internal models, it should also advise on criteria to improve harmonisation of the modelling.

### **3.7. Solvency Capital Requirement standard formula**

#### *a) Interest rate risk*

EIOPA is asked to assess whether the calibration of the interest rate risk sub-module with the standard formula adequately reflects the risks faced by insurers, taking into account the low interest rates environment, and in

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<sup>10</sup> <https://eiopa.europa.eu/Publications/Requests%20for%20advice/Request%20for%20information%202018-04-25.pdf>

case this analysis points towards flaws, to advise on how these could be remedied. When making recommendations, EIOPA should ensure that any new calibration is appropriate for all currencies in the EEA, and should take into account the potential interactions with the parameters of the risk-free interest rate term structure.

*b) Counterparty default risk module of the Solvency Capital Requirement standard formula*

EIOPA is asked to assess the proportionality of the overall structure and of the counterparty default risk module, and to provide, where appropriate, advice on methods and calibrations for a simpler approach. Where this approach would necessitate a review of the allocation of asset classes to either market risk or counterparty risk modules, such a review should be conducted consistently with the review of the market risk module.

*c) Simplified calculation of the Solvency Capital Requirement standard formula*

EIOPA is asked to report on the application of the life and SLT health underwriting risk modules, as well as on the non-life lapse risk sub-module, identifying any divergent application of insurance and reinsurance undertakings. In particular, EIOPA is asked to report on areas where supervisory experience indicate the need for additional simplified calculations as referred to in Article 109 and 111(1)(l) of the Solvency II Directive and where appropriate propose relevant methods.

*d) Calibration of underwriting risk*

Where stakeholders provide material data of sufficient quality, EIOPA is asked to assess whether that would form a more representative basis for the calibration of underwriting stresses than the calibration on which the current factors are based.

*e) CAT risks in the Standard Formula*

In its second set of advice on specific items in the Solvency II Delegated Regulation (EIOPA-BoS-18/075), EIOPA had advised a method to capture specific insurance policy conditions (in particular contractual limits or sub-limits) that deviate significantly from the national market average conditions in the standard formula natural catastrophe calculation. In order to facilitate the application of that approach, EIOPA is asked to provide the national market average conditions that underlie the calibration of the natural catastrophe risk submodule.

### **3.8. Risk-mitigation techniques and other techniques used to reduce Solvency Capital Requirements**

EIOPA is asked to advise on methods for the recognition of the most common non-proportional reinsurance covers for non-life underwriting risks in the Solvency Capital Requirement standard formula, as well as for adverse development covers and finite reinsurance covers.

In this context, where EIOPA would consider that the methods set out in its “Guidelines on application of outwards reinsurance arrangements to the nonlife underwriting risk submodules” continue to be relevant, EIOPA is asked to assess the extent to which amendments to the legislative framework are necessary to incorporate these methods in the Solvency Capital Requirement standard formula.

EIOPA is also asked to clarify the definition of a financial risk-mitigation technique and of other financial instruments that may be used to reduce Solvency Capital Requirements, with a view to ensure a consistent treatment between the standard formula and internal models. EIOPA should also indicate the criteria and the methods to determine the amount of risk reduction or risk transfer that may be recognized for such items.

EIOPA is also asked to analyse whether the provisions on the assessment of basis risk are sufficiently clear and, where appropriate, advise on improvements.

### **3.9. MCR**

EIOPA is asked to report on Member States' rules and supervisory practices adopted pursuant to the adoption of paragraphs 1 to 4 of Article 129 of the Solvency II Directive. In particular, EIOPA is asked to report on the following items:

- quantitative and qualitative information with regard to the use and the level of the cap and the floor set out in paragraph 3 of Article 128, as well as of the absolute floor referred to in paragraph 1(d);
- potential issues faced by supervisors with regard to the calculation of the Minimum Capital Requirements and where applicable, recommendations on how they could be addressed;
- an assessment on whether the rules governing the calculation of the Minimum Capital Requirement continue to be consistent with a Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 85% over a one-year period;
- potential divergences in supervisory practices in cases of non-compliance with the Minimum Capital Requirement, with regard to the withdrawal of authorization, including the timing of withdrawal, the supervisory powers following the withdrawal of authorisation, as well as to the restriction or prohibition of free disposal of assets;
- potential issues with regard to the identification of eligible basic own funds items for composite undertakings, in accordance with Article 73(3) of the Solvency II Directive and where applicable, recommendations on how they could be addressed.

### **3.10. Macro-prudential issues**

EIOPA is asked to assess whether the existing provisions of the Solvency II framework allow for an appropriate macro-prudential supervision. Where EIOPA concludes that it is not the case, EIOPA is asked to advise on how to improve the following closed list of items:

- the own-risk and solvency assessment;
- the drafting of a systemic risk management plan;
- liquidity risk management planning and liquidity reporting;
- the prudent person principle.

This assessment should be based on strong supporting evidence, also assessing the possible impact of such additional specifications of insurers' behaviour and possible interactions with other Solvency II instruments.

### **3.11. Recovery and resolution**

EIOPA is asked to assess whether the Solvency II rules on the recovery of undertakings in stressed situations should be further developed, including harmonised early intervention powers and preventive recovery planning. EIOPA is further asked to advise on which elements and rules should be added.

Similarly, EIOPA is asked to advise on whether there is a need for minimum harmonised rules regarding resolution of insurance or reinsurance companies, including resolution planning. In addition, EIOPA is asked to advise on which tools should be created to address the failure or the risk of failure of insurance or reinsurance companies as well as on what the scope of resolution planning should be.

Furthermore, EIOPA is asked, taking into account the experience with supervisory powers in cases of non-compliance with the Solvency Capital Requirement and the Minimum Capital Requirement, to advise on what the appropriate triggers for early intervention, entry into recovery and entry into resolution should be.

### **3.12. Insurance guarantee schemes (IGS)**

EIOPA is asked to advise on whether there is a need for minimum harmonising rules for national insurance guarantee schemes. In particular, EIOPA is asked to advise on whether the rules in the following areas need to be harmonised: role and functioning of IGSs, their geographical coverage, cross-border coordination mechanisms, eligible policies, eligible claimants, funding, and policyholder information.

In the context of policies sold via free movement or services or branches, EIOPA is, in particular, asked to consider whether possibly harmonised rules for national insurance guarantee schemes should enable a recourse to the IGS of the home Member State in order to protect policy holders in the other Member States where the undertaking is operating.

Where EIOPA identifies a need to harmonise rules, it is asked to advise which principles should apply.

### **3.13. Freedom to provide services and freedom of establishment**

EIOPA is asked to assess whether the current supervisory powers at the disposal of the home National Supervisory Authorities and of EIOPA are sufficient to prevent failures of insurance companies operating cross-border through freedom to provide services and the freedom of establishment, and to properly assess the fit-and-proper requirements.

### **3.14. Group supervision**

EIOPA is asked to advise on how the main issues identified in its Report on group Supervision and Capital Management of Insurance of Reinsurance Undertakings published on 19 December 2018 could be remedied. In particular, EIOPA is asked to focus on the following items:

- the scope of application of group supervision and the supervision of intra-group transactions, including the supervisory powers in cases where the parent company is headquartered in a non-equivalent third country;
- the rules governing the calculation of group solvency, when method 1, method 2 or a combination of methods is used, including own-funds requirements and the interactions with Directive 2002/87/EC (hereafter “FICOD”);
- the appropriateness of the rules governing the calculation of the minimum consolidated group Solvency Capital Requirement, including their impact on the level of diversification benefits that may be allowed within a group;
- uncertainties or gaps related to the application of governance requirements at group level.

### **3.15. Reporting and disclosure**

EIOPA is asked to assess, taking into account stakeholders’ feedback to the Commission public consultation on fitness check on supervisory reporting:

- the ongoing appropriateness of the requirements related to reporting and disclosure, in light of supervisors’ and other stakeholders’ experience;
- whether the volume, frequency and deadlines of supervisory reporting and public disclosure are appropriate and proportionate, and whether the existing exemption requirements are sufficient to ensure proportionate application to small undertakings.

### **3.16. Proportionality and thresholds**

EIOPA is asked to assess whether proportionality in the application of the Solvency II framework could be enhanced, and in particular in the following areas:



- the appropriateness of the thresholds for the exclusion from the scope of Solvency II, as defined in Article 4 of Directive 2009/138/EC;
- the possibility to waive certain requirements relating to any of three Pillars of the framework based on size thresholds or the nature of the undertaking or of its risks;
- rules for the simplified calculation of sub-modules that form an immaterial part of the Solvency Capital Requirement of an individual insurance or reinsurance undertaking.

### **3.17. Best estimate**

EIOPA is asked to report on divergent supervisory practices with regard to the calculation of the best estimate, and to provide quantitative information on their impacts, in particular with regard to the following items:

- the use of economic scenario generators for the purpose of calculating the best estimate of life obligations;
- the application of the definition of contract boundaries;
- the application of future management actions including those in the context of highly profitable scenarios and those linked to "lapses/surrenders";
- the treatment and evaluation of expenses, investment costs and the valuation of options and guarantees.

Where this analysis would point towards the identification of flaws or significant supervisory divergences, EIOPA is asked to advise on how these could be remedied.

### **3.18. Own funds at solo level**

The tiering structure of own funds in the Solvency II framework significantly differs from the one applicable to under Directive 2013/36/EU and Regulation (EU) No 575/2013.

Therefore, EIOPA is asked to report and where appropriate to provide advice, on the following items:

- whether the differences in the tiering approaches between the insurance framework and the banking framework are justified by differences in the business models of the two sectors<sup>11</sup>;
- the extent to which the tiering structure of own funds in the Solvency II framework may generate undue volatility of own funds;
- whether the availability criteria for own funds are sufficiently clear and appropriate.

In addition, EIOPA is asked to assess whether the items currently included in Solvency II own funds are appropriately attributed to tiers according to the characteristics of permanent availability and subordination.

### **3.19. Reducing reliance on external ratings**

The Commission is working towards reducing the references to external credit ratings for regulatory purposes. In the specific context of the insurance sector, the review of the Solvency II Delegated Act has already provided insurers with new methodological approaches to assess credit risk for unrated debts (namely the "internal assessment approach" and the "internal model approach").

Beyond the scope of the proposed amendments in the context of the review of the Delegated Act, EIOPA is therefore asked to advise on additional methods allowing for a wider use of those alternative credit assessments. Such an approach may target corporate exposures that are also rated by credit rating agencies,

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<sup>11</sup> For instance, the banking regulation does not include Tier 3 own-funds and does not impose any upper limit on the amount of eligible Tier 2 own-fund items.

and should be commensurate to the nature, scale and complexity of the risks to which the undertaking is exposed.