BRIEFING

Scrutiny papers

European Parliament

Review of the Solvency II implementing measures

Committee on Economic and Monetary Affairs

Scrutiny Session of 16 May 2018

This briefing has been drawn up to support ECON's work on the scrutiny of delegated acts, in particular as regards the discussion on the review of the implementing measures under **Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance** (Solvency II[1]) .

In brief

Solvency II became fully applicable on 1 January 2016, aiming to introduce a modernised risk-based prudential and supervisory regime for insurance and reinsurance undertakings in the European Union. Two years after the entry into application, the Commission is now conducting a review of the implementing measures contained in **Delegated Regulation (EU) 2015/35** ("Solvency II DA"), adopted on 10 October 2014. The Solvency II DA was already updated in the context of the Capital Markets Union (CMU), reviewing risk calibrations for **infrastructure investments**. Before the overall **review of Solvency II** by 2021, and in parallel with the review of specific items of the Solvency II Capital Requirement Standard formula (SCR) through the Solvency II DA, the Commission is preparing further updates in the context of the CMU, related to the treatment of **simple, transparent, and standardised (STS) Securitisation investments by insurers.** This briefing focuses primarily on the SCR review of the Solvency II DA, for which the Commission identified three themes: proportionality, the removal of unintended technical inconsistencies, and the removal of unjustified constraints for financing

CAPITAL MARKETS UNION: INFRASTRUCTURE AND STS SECURITISATION INVESTMENTS

As part of its Capital Markets Union (CMU) initiative, the Commission amended the Solvency II DA on 8 June 2017 with more risk sensitive calibrations for infrastructure and European long term investment funds. Capital charges for debt investments in qualifying infrastructure corporates were on average reduced by 25%. CMU furthermore included the intention to amend the Solvency II DA by including new prudential calibrations for simple, transparent and standardised (STS) securitisation products. Before the application date of the

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[1] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 335, 17.12.2009, p. 1–155.

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STS Regulation[2], 1 January 2019, the Solvency II DA is to be updated to ensure consistency with this framework. On 17 April 2018, the Commission published a first draft of the STS amendments for a four-week public feedback period. The draft amendments to the Solvency II DA, which the Commission intends to adopt in the summer of 2018, include changes concerning:

- **New risk calibrations** for non-senior tranches of STS securitisations, with technical improvements also to be made for calculations of the calibrations for senior tranches.
- **An alignment of the definitions** concerning securitisation of the Solvency II DA with the STS Regulation.
- **A repeal of certain articles of the Solvency II DA** related to risk retention and due diligence, to avoid that insurers are subject to different requirements in their capacity of institutional investors under the STS Regulation.

EIOPA TECHNICAL ADVICE ON THE SCR STANDARD FORMULA REVIEW

Recital 150 of the Solvency II DA foresees a review of the methods, assumptions, and standard parameters used for the calculation of the Solvency Capital Requirements (SCR) with the standard formula. Following a consultation phase that closed early 2018, EIOPA published two sets of technical advice on specific items in the Solvency II DA (*see overview on page 4)*. The Commission is to perform its review of specific items of the SCR standard formula before December 2018. As per two calls for advice ("mandates"), given by the Commission, EIOPA's advice contains three themes: proportionate and simplified application of the requirements, removal of unintended technical inconsistencies and removal of unjustified constraints for financing.

Proportionate and simplified application of the SCR standard formula requirements

Following Article 29(4) of Solvency II, all implementing measures adopted shall take into account the principle of proportionality, in particular in relation to smaller insurers. Aiming for a proportionate and simplified application of the SCR standard formula requirements, EIOPA e.g. covered existing simplifications, the non-life catastrophe risk sub-module, and the counterparty default module:

- In general, EIOPA recommends to allow for more flexibility in the calculations, by means of optional **simplified formulas** for the calculation of risk such as lapse and life and health mortality and a reduced data-collection burden.
- EIOPA suggests a simplification of the **look-through approach**, e.g. through a "carve out" from the 20% limit for unit linked and index linked products under certain conditions, and the possibility to use the latest reported fund composition where the look-through approach cannot be applied. As for technical inconsistencies (*see below),* EIOPA also suggests aligning the scope of the look-through approach with respect to investments in non-consolidated related undertakings between the solo and group level.

Removal of unintended technical inconsistencies

Recital 150 of the Solvency II DA foresees that the Commission uses experience gained by (re)insurance undertakings in its SCR Review. For EIOPA, after engaging with stakeholders, this e.g. included:

- The analysis of **risk mitigation techniques** (RMT) on which EIOPA for example recommends better recognising rolling hedging strategies where the RMT is regularly replaced with the same or similar

[2] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, OJ L 347, 28.12.2017, p. 35–80.

instruments. The advice does not put forward a recognition of certain reinsurance contracts to cover adverse developments, as requested by some stakeholders.

- EIOPA proposes revised **recalibrations** for the non-life premium and reserve risk standard deviations in medical expense, credit and suretyship, assistance, legal expenses, and worker's compensation. The mortality and longevity stresses are still considered adequate.
- EIOPA recommends that the **cost of capital** rate of 6% remains unchanged and that other aspects of the risk margin should be addressed in the upcoming Solvency II overall review (*see below*).
- At its own initiative, whilst not welcomed by all stakeholders (1, 2, *see below*), EIOPA also proposes recalibrations in the **interest rate risk module** to adjust to an economic environment with negative risk-free interest rates, currently not covered in the calculation for capital requirements. EIOPA suggests that the Commission addresses this by modelling the interest rate risk with a relative shift approach, with parameters depending on maturity. Given the material impact of the proposed calibration, EIOPA recommends a phasing in schedule over no more than 3 years.
- As for the assessment of credit risk and the reduction of the reliance on "**External Credit Assessment Institutions"** (ECAIs) ratings in the SCR, EIOPA suggests simplifying calculations for the credit risk module by nominating only one if the ECAI covers 80% of the debt portfolio. In this case, the insurer may assume that the assets not covered by the ECAI are of Credit Quality Step 3 unless there is evidence that a significant part is of lower credit quality.
- EIOPA also looked at means to create **consistency across financial sectors** and concluded it is necessary to extend the scope for the recognition of guarantees issued by regional governments and local authorities (RGLA) to align insurance with the banking framework (Directive 2013/36/EU (CRD) and Regulation (EU) No 575/2013 (CRR)). A second proposal for a CRR-alignment consists of two approaches for exposures to members of central counterparties (CCPs).
- Following its analysis, in its first advice, of practices to calculate **the loss-absorbing capacity of deferred taxes** (LAC DT), EIOPA proposes to address divergences herein through a set of nine key principles. Whilst not considered as a technical inconsistency that should be addressed by harmonisation by all stakeholders, the principles include various aspects of the projections of future profits and should lead to more convergence in the calculation of capital requirements.

Removal of unjustified constraints for financing

In the context of the CMU, EIOPA was also asked to consider changes to remove unjustified constraints to financing, mostly related to long-term investment. In particular, this concerns EIOPA's proposal regarding the treatment of **unrated debt and unlisted equity**. Suggestions aim to provide these asset classes with the same credit ratings and capital charges as rated debt and listed equity, enhancing insurers' capacity to invest in private placement offerings and in private equity. For unrated debt, this includes criteria put forward by EIOPA to assess in which cases the same treatment can be provided, related to financial ratios and yield. For unlisted equity, conditions relate to criteria on underlying equity investments, on vehicle, on own risk management and on similarity. EIOPA also provided information on the application of the Solvency II DA criteria for the identification of **strategic equity investments** by insurance and reinsurance undertakings as well as by National Supervisory Authorities ("NSAs").

THE REVIEW OF THE SOLVENCY II DIRECTIVE

The Solvency II DA furthermore foresees an overall **review of the Solvency II framework**, including the treatment of long-term guarantees (LTG) and measures on equity risk, to be completed by 1 January 2021. For this, EIOPA annually reports on the impact of the application of the LTG measures and the measures on equity risk, and will issue an opinion to the Commission on the basis of which the Commission will submit a report and, if deemed necessary, legislative proposals. Criticising the staged approach of the Solvency II review, stakeholders have suggested postponing in particular changes to the interest rate risk module until the review of the LTG package. According to the stakeholders, this would allow for a more complete impact assessment.

OVERVIEW OF EIOPA TECHNICAL ADVICE

	EIOPA's first set of advice			EIOPA's second set of advice		
		Legal base (Art.)			Legal base (Art.)	
		Level 1	DA		Level 1	DA
Area	Simplified Calculations	109, 111	88	Counterparty default risk simplification	104(1), 105(6)	107 - 112, 189 - 202,
	Look-through: investment related vehicles		84	Health, man-made and natural catastrophe risks	105, 109, 111	88, 114, 119 - 124, 126, 128, 144
	Risk-mitigation techniques	14(36), 101(5), 111(1)	83(4), 208 to 215			
	USPs	104(7)	218 - 220			
	Reducing reliance on external credit ratings	13(40)	4	Recalibration of standard parameters of premium and reserve risks	105	115, 146
	LAC DT	103, 108	9, 15, 76(a)(iii), 83(1)(b), 205, 207	Recalibration or mortality and longevity risks	105(3)	137-138, 152-153
	Treatment of guarantees, exposures guaranteed by a 3rd party and exposures to RGLA	109a(2)(a)	85, 180(2), 187(3), 199(11), 215	Volume measure for premium risk	105(2)	115, 116, 146, 147
				Interest rate risk	105(5)(a)	103, 165 - 167
				Market risk concentration	105(5)(f)	182 - 187
				Currency risk at group level		188(1), 337
				Treatment of exposures to CCPs	104(1), 105(6)	192, 199 - 201
				Look-through: group level, simplification	212, 221, 230	36, 84, 168, 335
				Risk margin	77, 86(1)(d)	37 - 39
				Sector comparison own funds	75(1), 138(3), (4)	9, 69, 71, 76
				Tier 1 quantitative limit	97, 99	82
				RMT allowed adjustments		209(3)
				Recognition of ADC		
				Unrated debt and unlisted equity		168(3), 169(2)(b), 176(4),(5)
				Strategic equity investment		169 - 171
Mandate	18 July 2016			21 February 2017		
Discussion Paper	5 December 2016			*(idem)*		
Consultation Paper	4 July 2017			6 November 2017		
Final Report	30 October 2017			28 February 2018		