Joint industry comments on EIOPA's opinion on the 2020 review of Solvency II

January 2020

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1. Executive summary

The industry welcomes the opportunity to provide its views regarding the ongoing Solvency II review, and to comment on EIOPA's draft proposals.

The 2020 review of Solvency II provides a key opportunity for supervisors, regulators and the industry to improve the design and calibration of the framework. Beyond this, the Solvency II review has to be regarded in the context of the broader economic and environmental realities that Europe is facing, and the ambitions for the future that have been set out by the European Union, jointly and individually at member state level.

Europe is currently facing major challenges related to achieving economic growth and technological innovation, global competitiveness and addressing climate change and the aging society. These challenges are, with good reason, at the centre of discussions within the European Council, Parliament and Commission, and across member states at national level.

For achieving the objectives and addressing the challenges above, Europe needs more long-term investment, attractive retirement options including long-term guarantees and coverage of emerging risks associated with technological innovation and climate change. Insurers, with their long-term business model, are committed and well placed to play a major role in helping to address these needs.

Solvency II has a major impact on the insurance industry. Capital and other requirements drive the industry's capacity to cover risks, the ability to offer guarantees and the level and type of investments that can be made. For four years now, insurers have been subject to the Solvency II regime and overall it works well. Its risk-based approach remains strongly supported and it has been instrumental in widening and deepening the already very high standards of risk management and customer protection across Europe. However, Solvency II does require targeted important improvements and the current review process is necessary and welcome.

As made clear over recent years, the European insurance industry supports the aims of Solvency II and its strong risk-based nature. Solvency II was introduced not because of a solvency problem, but to harmonise diverging local insurance regulations, to align regulatory practices to the modern capital and risk management approaches being used by many companies and to ensure all customers across the EU are given consistent high levels of protection against insolvency.

The recent years of application have shown that Solvency II has achieved its overall objectives and in many respects is working reasonably well, but it requires a limited set of focused changes. Therefore, the review should focus on addressing the following areas where there are known and important problems to address: the treatment of long-term business, proportionality and reporting.

The industry is disappointed by EIOPA's draft proposals for the Solvency II 2020 review. **EIOPA proposes a significant overhaul of the framework with a very large number of changes.** Its more than 120 proposals for changes (and associated proposals for new guidelines) amount to a revolution rather than evolution and would result overall in significant increases in capital requirements, operational burden for insurers and new powers for supervisors. There is no strong evidence that these changes would provide significant and effective prudential benefits. Such outcomes would in fact reflect a worsening rather than an improvement of the framework.

The industry therefore encourages EIOPA to streamline its proposals in ways that lead to a **review focused on appropriate outcomes**. Specifically:

- In its capacity as technical advisor, **EIOPA should be objective and also include options which could result in release of capital** and recommend these where justified. Examples include: lowering the level

and volatility of the risk margin; improvements in the volatility adjustment; extension of the dynamic volatility adjustment to standard formula users; other elements of the standard formula such as equity risk, spread risk, property risk and lapse risk.

- EIOPA should primarily **provide solutions and put the necessary effort into areas explicitly requested by the EC**, such as criteria for a stable LLP rather than on diverse options for the LLP and own-initiative proposals in the area of macroprudential supervision. Another example where more work is needed is the treatment of non-proportional reinsurance in the standard formula, which EIOPA itself recognises is flawed and needs improvements, as well as improvements in the new long-term equity category.
- EIOPA should take a **pragmatic approach** and **avoid proposals based on purely theoretical concerns**, which in practice would either not work at all or the burden of implementing them would not be justified. One clear example is the area of group supervision, where 32 proposed changes are put forward, largely on the basis of theoretical concerns, without a clear global objective, and which in practice could create significant challenges and/or additional costs (and the industry provides some examples of such challenges in the detailed response).
- Similarly, EIOPA should **avoid the creation of new NSA powers without clear evidence** that this is needed and/or why the existing powers are not sufficient. EIOPA should also **not create a "shadow" Solvency II regime** based on isolated calculations that ignore key elements of the framework. Clear examples are the creation of "shadow" SCRs on the basis of theoretical assumptions that eg the VA/the MA did not exist, the UFR was reduced by 100bps and the EUR LLP was 50 years. Solvency II was designed with a minimum capital requirement (MCR) and very conservative SCR above that in order to create an early intervention point with a ladder of intervention in between. Introducing new intervention powers before the SCR is breached undermines the key role of the SCR which is already very prudently set at the 99.5th percentile. Such changes would further increase the burden of the Solvency II regime with costs and consequences for customers and for insurers' role as investors and would also further challenge the competitiveness of European insurers internationally.
- EIOPA should be **more ambitious in its proposals on reporting and proportionality**, to achieve its own stated goals of streamlining disclosures and enhancing proportionality. Unfortunately, the draft proposals are far from achieving the intended aims and, if anything, in the area of reporting EIOPA's proposals seem to increase rather than decrease the burden on the industry.

Looking ahead, the industry expects that any changes contemplated by EIOPA (via either regulatory requirements, guidelines or other tools) as well as counter-proposals from the industry are included in the **holistic impact assessment**. This was requested by the Commission and represents a key element of the steps needed to arrive at an appropriate set of changes.

We highlight and summarise below our key positions on each area of the advice:

LTG Measures and measures on equity risk

The LTG measures and measures on equity risk have a significant impact on the availability and cost of long-term products and insurer's long-term investments. In many respects, the measures have worked well but certain focused improvements are needed to ensure Solvency II appropriately reflects the real economics and risks relating to insurers' long-term business model. The industry only supports changes to the LTG measures and measures on equity risk which better reflect long-term business. Appropriate improvements will result in justified reductions in overall capital requirements and less artificial volatility for long-term products and investments and therefore reduce unnecessary barriers while maintaining the very high levels of policyholder protection set by Solvency II.

However, several of the standalone options considered by EIOPA and, in particular, the overall combinations of proposed changes would be very detrimental to the industry and policyholders. They are often based on highly-theoretical considerations, do not reflect the economics of the insurance business model and appear to have been developed in silos.

The industry does not support any changes proposed by EIOPA to the extrapolation methodology or parameters used to derive the risk-free rate curve. The industry also strongly disagrees with the proposal to give NSAs powers to limit capital distributions based on a 50 year LLP extrapolation. The risk-free rate curves can play a core role in product design, product pricing, asset liability management, investment strategy and hedging strategies. Insurers can take into account potential market movements and their impact on the risk-free rates but changes to the underlying methodology and fixed parameters can create very significant problems. EIOPA's analysis shows that market liquidity has not changed in ways which would justify a LLP higher than 20 years, if anything it could indicate a 15 year last liquid point. There is also insufficient evidence to justify EIOPA's proposed change of the extrapolation methodology for the Euro or other currencies. Furthermore, an extension of the LLP could also have a procyclical effect. The industry seeks stability of the risk-free curves methodology.

On the Matching Adjustment (MA), the industry supports EIOPA's intended improvements.

On the Volatility Adjustment (VA), the industry notes that the VA is a widely-used measure and strongly supports focused improvements. These should focus on 1) increasing the general level of the VA to properly reflect the ability of insurers to earn returns above risk-free rates and 2) avoiding artificial balance sheet volatility. The effectiveness of improvements should be tested against normal and stressed market conditions and across member states. Neither of EIOPA's proposed approaches would achieve the necessary outcomes while introducing significant complexity.

In relation to some of the specific options on the VA that EIOPA includes, the industry does not support proposals for changes to the risk corrections because this moves away from its key purpose as a reflection of the expected cost of defaults, reduces the effectiveness of the VA and amplifies pro-cyclicality. The industry also does not support the introduction of liquidity penalties (through the proposed "adjustment for illiquidity of liabilities"). The introduction of this option would be overly conservative given that liquidity is already addressed through Pillar 2 and Pillar 3 requirements of the Solvency II framework.

The Dynamic Volatility Adjustment (DVA) should be retained in internal models as they are an essential and functioning approach to properly reflect movements in own funds in the calculations of the capital requirements in line with the Solvency II Directive. For this reason, it should be extended to the standard formula to resolve the incorrect treatment of the impact of corporate spread movements in Solvency II (see section 5 on SCR standard formula for further views).

EIOPA's proposals to give powers to NSAs to limit capital distributions based on a type of ultra-conservative shadow SCR[1] creates a requirement which is significantly beyond the agreed 1-in-200 Solvency II confidence level and which is based on non-reliable information from markets which are not deep and liquid. Thus, it is to be decisively rejected. The requirement to publicly report solvency positions without the VA and MA should be removed to avoid confusion over the actual solvency position of the company. For the same reason there should be no requirement to publish the solvency position with UFR 100 basis points down.

On the equity risk SCR, there is a need to ensure the new long-term equity category works in practice so that the lower risk faced by insurers with long-term products and related equity investments is correctly captured and barriers against investing in the real economy are reduced. Care must be taken in this area (and in fact all areas) to avoid so many or so constraining criteria that results, as can be seen with the example of duration-based equity module, in nil or almost nil application in

[1] Shadow SCR means requiring insurers to test solvency without VA, MA and transitional measures and stressed extrapolation parameters of a 50 year LLP and a 1% reduction in the UFR

practice. In fact, equity under Solvency II has been under various reviews in recent years (eg infrastructure equity, unlisted equity, long-term equity, equity held in specific collective investments). Today there is no clear analysis on the extent to which these sub-classes of equity have found a practical implementation that ultimately achieves the goals that were intended by the legislators, namely to remove barriers to investment by applying excessively high capital requirements.

The industry does not support changes to the existing transitional measures or new restrictions on their application.

Technical provisions – best estimate

The industry supports EIOPA's clarification that it is a 'right' rather than an 'obligation' for insurers to perform an assessment at the level of individual contracts, the definition for Future Management Actions and the clarifications made for expenses.

However, the industry disagrees with the changes proposed in relation to the calculation of EPIFP. In addition, the industry does not see the added value of introducing a definition for the gross expected future profit/loss from servicing and management of funds.

Regarding contract boundaries, the industry disagrees with EIOPA's proposal to introduce new requirements. This is an example of harmonising goldplating of Solvency II.

Technical provisions – risk margin

The industry is disappointed by EIOPA's decision to maintain the status quo. EIOPA does not address the issues relating to the risk margin (RM) nor fix its flaws. In the CfA EIOPA is explicitly asked to 'assess the ongoing appropriateness of the assumptions used to derive the CoC, including the absence of leverage and the derivation of the ERP.

The RM is excessively high, especially for long-term business and its excessive sensitivity to interest rates is another source of artificial volatility. These issues are particularly problematic for long-term products. The industry highlights that there are a range of technical arguments which, taken together, support a significant reduction in the RM. EIOPA should put more effort into this area as mandated in the CfA.

Own funds

The industry welcomes EIOPA's acknowledgement of the differences between the insurance and the banking sectors, and the corresponding advice not to align the tiering structure to banking regulation.

The industry disagrees with EIOPA's analysis of the concept of "double leverage" and notes that Solvency II already provides for the elimination in group solvency of the double use of eligible own funds and of the internal creation of capital.

The industry agrees with EIOPA's draft advice to not change the treatment of EPIFPs but does not agree that further work is needed. EPIFPs are an important part of the Solvency II framework allowing the reflection of economic reality, with respect to the principle of going concern. As such, they are a useful element, notably to encourage the offer of long-term guarantees. EIOPA seems to regard a positive value of EPIFPs as something negative that should be limited, which is a conservative approach and is contrary to the Solvency II principle of going concern. EIOPA should not undermine EPIFPs by limiting their eligibility or downgrading their tiering.

Solvency Capital Requirement standard formula

The current capital requirements for market risk do not properly reflect the real economic risks to which insurers are exposed. The industry is disappointed by EIOPA's advice on the calibrations of standard formula submodules.

EIOPA’s proposal on the recalibration of interest rate risk is based on overly theoretical and hypothetical views on how low interest rates can go. Also, EIOPA’s use of factor-based stress for the extrapolated part of the interest rate term structure is economically incorrect and creates an inconsistency with the calculation of the liabilities. Its proposals would create excessive capital requirements.

Negative rates are a reality. There is, however, no evidence that the extreme levels of negative rates implied by EIOPA’s methodology are justified or even possible. Any change to the current interest rate SCR methodology needs to include a floor which reflects the reality of negative rates without hypothesising about the future and also consider the impact on the business model. It is equally important that the shock is only applied up until the last liquid point.

The industry supports the extension of the dynamic volatility adjustment to the standard formula to resolve the incorrect treatment of corporate bonds within Solvency II. A decrease of the property risk shock to better reflect the underlying risk based on pan-European data is supported.

The lapse risk submodules need revision because they are set too high and exclude contracts which, in reality, would have a mitigating effect. The correlation parameter between interest rate down risk and spread risk should also be reduced to reflect the evidence presented by EIOPA.

On risk mitigation, the industry is disappointed that EIOPA has not proposed potential solutions to address the flaws in the current standard formula relating to non-proportional reinsurance and basis risk.

On counterparty default risk, the industry supports policy option 3 which EIOPA’s own analysis identifies as the most technically correct and least burdensome. It is therefore surprising that EIOPA has opted to support policy option 2 which is incorrect and creates a higher calculation burden for insurers.

Minimum capital requirement

The industry welcomes EIOPA’s proposal not to change the calculation of the MCR corridor.

The industry disagrees with EIOPA’s proposal to add specific requirements in relation to the ladder of intervention in case of risk of breach of the MCR. The NSAs already have sufficient powers to intervene when necessary so no additional provisions are needed. Preserving flexibility for NSAs’ action is most likely in the best interest of policyholders.

As part of the simplification of Solvency II reporting, EIOPA should delete the template on reporting of notional MCRs for composite undertakings (template S.28.02.01). In fact, EIOPA’s own analysis shows that this is of limited value, that it cannot be used properly by NSAs, and that deleting it would reduce the burden without jeopardising policyholders’ interests.

Reporting and disclosure

The industry welcomes that EIOPA has stated in its earlier reporting consultation the intention to reduce the reporting burden. While there are some positive proposals, taken as a whole EIOPA’s proposals will increase rather than decrease the overall burden.

On the QRTs the industry has the following views:

- It welcomes that EIOPA has proposed deletion of a number of rarely used QRTs but other QRTs could also be deleted.
- It supports the proposal to allow for exemption of group reporting without the condition of exemption of all solo insurance undertakings belonging to that group.
- It disagrees with the proposals to introduce standard formula reporting requirements for internal model users, which are onerous, unnecessary and misleading.

- It disagrees with the proposed changes to a large number of existing QRTs, which would be costly and not justified by the supervisory benefits.
- Q4 reporting should be eliminated.

For the SFCR:
- The industry welcomes the removal of translation requirements for group SFCR.
- It strongly disagrees with proposals for new auditing requirements.
- It does not support the addition of various reporting and disclosure proposals which are spread across this consultation (eg on VA, risk management/disclosure provisions on LTG measures, best estimate and extrapolation).
- SFCRs should be simplified so that they consist of only a very short simple policyholder section and a simple data extraction of the public QRTs data without any set requirements for a narrative.

On the RSR:
- The default frequency of the RSR should be harmonised at 3 years and groups should have the option to produce a single group RSR. The industry is disappointed that its proposals in this area have not been included in the draft opinion.
- The industry does not believe the proposals to revise the structure and content of the RSR will reduce the burden and notes that some of the proposed reductions of the SFCR are simply moved to the RSR.

Proportionality and thresholds

The industry supports EIOPA's proposal on thresholds, eg the option for member states to raise the premium income threshold up to €25m.

The industry welcomes the Commission's ambition to improve the application of proportionality in Solvency II. Changes are necessary to ensure that any insurer can avoid, based on the scale, nature and complexity of its activities, unnecessary costs which ultimately would have to be borne by policyholders.

The industry supports EIOPA's efforts to improve proportionality, but its proposals are far from enough to ensure an effective and efficient application of proportionality. The following additional changes are needed to ensure that proportionality will work in practice and will be available as a potential tool for all companies:
- The Directive must make clear that NSAs have a duty to always consider where they should allow companies to deviate from any specific requirements due to proportionality considerations, either by using approximations, simplified approaches or by not applying a requirement where appropriate.
- A "tool-box" needs to be created of non-exhaustive pre-defined simplifications (alternative calculation methods and/or exemptions from certain reporting templates) that can be automatically applied by companies when some predefined and risk-based criteria are met.
- In the context of the committee on proportionality created by the ESAs review, EIOPA should publish an annual report on proportionality. The report would evaluate the application of the proportionality principle per member state and make proposals on how to improve its effectiveness and consistency (similar to the EIOPA report on the use of limitations and exemptions from reporting).

Furthermore, the industry notes that applying proportionality should not result in gold plating, and proportionality should not be mis-used to increase the burden for some insurers.

Group supervision

The industry broadly disagrees with EIOPA's numerous (over 30 in total) proposals for changes in the area of group supervision.

Most of these measures aim at improving convergence of supervisory practices. While there may be a need for improvement, this should not be achieved by changes to the legislation, but more appropriately through the supervisory handbook, workshops, colleges of supervisors, etc. These tools also foster dialogue between NSAs,

and between EIOPA and NSAs, and help foster better understanding as to why and how in some cases divergent practices are justified by the specificities of particular groups. This also avoids removing the existing flexibility in the regulation, much needed to ensure NSAs can adapt to the various structures and risk profiles of groups. In any case, where EIOPA chooses to arbitrate via any tool, all measures must be prior subject to a detailed impact assessment, as some proposals may entail a significant impact on the solvency position of groups or have other unintended consequences. Moreover, in view of the proposed amendments regarding group own funds and group solvency, it is crucial that the potential effects of these amendments are considered together with the effects of amendments at solo level.

The industry is in particular concerned by the broadening of the scope of the minimum consolidated group SCR to include insurance holding companies and mixed financial holding companies. As EIOPA proposes to leave the calculation of the minimum consolidated group SCR unchanged, this would increase the risk that it is breached before the group SCR (trigger inversion) and thereby would exacerbate the existing weaknesses of the minimum consolidated group SCR's design. The addition of currency and concentration charges on undertakings aggregated with method 2 (D&A) is equally concerning, as it appears to be adding prudence where several prudent buffers are already in place. This could easily lead to additional double counting of risks which EIOPA tries to avoid, and would have a substantial capital impact on groups.

Moreover, the proposals to consider EPIFPs and benefits from transitional measures on technical provisions and interest rate as unavailable by default at group level are inappropriate and do not reflect economic reality. These measures can have a material negative effect on group solvency and the group SCR while at the same time diminishing the risk sensitivity of Solvency II.
In addition, the proposed additional powers for NSAs to restructure a group, or to choose which company would be designated as responsible for horizontal groups are overly intrusive and too far-reaching compared to the (theoretical) benefits.

Further, there is no need for new clarifications on definitions and additional requirements where no specific issues were reported and the only justification is purely theoretical/hypothetical. Any change could result in costs and burden, and therefore changes should only be made when there is strong evidence that it is necessary and justified on a cost/benefit basis. When specific issues occur, they can already be solved by the NSAs and the supervisory colleges on an ad-hoc basis.

As stated in the previous section, measures to increase proportionality are welcome also in the area of group supervision. NSAs must be allowed, encouraged and required to allow proportionality, where appropriate to the risks of the group, including where it leads to a deviation from detailed requirements mentioned in the regulation.

Freedom to provide services and freedom of establishment

The industry welcomes EIOPA's recommendations to enhance the supervision of insurance companies operating cross-border through the freedom to provide services (FOS) and the freedom of establishment (FOE), in order to prevent their failures and properly assess the fit and proper requirements.

In particular, the efforts to strengthen cooperation between home and host NCAs by increasing obligations for both and increasing home NCAs' responsibility in respect of their insurers' cross-border activities are welcome. The suggested means, which will give EIOPA the necessary tools to intervene where cooperation between NCAs is not sufficient (or where it fails) are also welcome. It is essential for the level of control to be the same across Members State, whether business is done in the home market or in another market via the FOS/FOE.

Macroprudential policy

In light of the limited systemic risk that the insurance sector poses, and the comprehensive protection provided already by Solvency II, there is no justification for new measures that would result in significant initial and/or ongoing costs. The industry recognises that there is now an international framework for addressing systemic risk, and that the EC CfA reflects this framework to a large extent.

Therefore, only measures that have been specifically referenced in the European Commission's CfA (enhanced ORSA and PPP, LRMPs, SRMPs, pre-emptive recovery and resolution plans) should be considered and, if introduced, they should be implemented with strong proportionality provisions and only when the existing Solvency II framework can be shown to be insufficient to tackle identified material systemic risks and when it can be clearly demonstrated that the benefits of applying these new measures outweigh the costs.

There would be no justification to consider in Solvency II measures that go beyond the EC CfA and holistic framework for all the reasons mentioned above, but also because this would place Europe at a competitive disadvantage compared to other jurisdictions. Unfortunately, EIOPA has made a number of proposals which go beyond the EC CfA and the holistic framework, and the industry strongly opposes this. In particular, the industry strongly opposes awarding supervisory powers to apply new capital surcharges for systemic risk as well as any new intervention powers before the SCR is breached.

Recovery and resolution

With respect to EIOPA's proposals relating to pre-emptive recovery planning, these seem to be broadly in line with the holistic framework, however a risk-based approach and proportionality are essential. It is important to ensure that this requirement is only applied to companies where planning would create a tangible benefit in terms of reduction of material systemic risk at EU level, not least because Solvency II already requires recovery planning from all companies when the SCR is breached. Therefore, there should be no requirement regarding recovery and resolution plans based on the coverage of the market share of the national market.

With respect to resolution measures, there is no justification for going beyond the global holistic framework. The industry also highlights that run-offs and portfolio transfers are sufficient to deal with the large majority of insurance failures. Therefore, the more drastic measures within the resolution toolkit proposed by EIOPA should be considered with caution.

There is no need for supervisory intervention in the day-to-day operations of healthy companies, in particular the removal of impediments for recovery and resolution and early intervention rights. Otherwise, Solvency II would be undermined under the guise of recovery and resolution requirements.

2. LTG measures and measures on equity risk

The LTG measures and measures on equity risk have a significant impact on the availability and cost of long-term products and insurer's long-term investments. In many respects, the measures have worked well but certain focused improvements are needed to ensure Solvency II appropriately reflects the real economics and risks relating to insurers' long-term business model. The industry only supports changes to the LTG measures and measures on equity risk which better reflect long-term business. Appropriate improvements will result in justified reductions in overall capital requirements and less artificial volatility for long-term products and investments and therefore reduce unnecessary barriers while maintaining the very high levels of policyholder protection set by Solvency II.

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The Dynamic Volatility Adjustment (DVA) should be retained in internal models as they are an essential and functioning approach to properly reflect movements in own funds in the calculations of the capital requirements in line with the Solvency II Directive. For this reason, it should be extended to the standard formula to resolve the incorrect treatment of the impact of corporate spread movements in Solvency II (see section 5 on SCR standard formula for further views).

EIOPA's proposals to give powers to NSAs to limit capital distributions based on a type of ultra-conservative shadow SCR[2] creates a requirement which is significantly beyond the agreed 1-in-200 Solvency II confidence level and which is based on non-reliable information from markets which are not deep and liquid. Thus, it is to be decisively rejected. The requirement to publicly report solvency positions <u>without the VA and MA</u> should be removed to avoid confusion over the actual solvency position of the company. For the same reason there should be no requirement to publish the solvency position with UFR 100 basis points down.

On the <u>equity risk SCR</u>, there is a need to ensure the new long-term equity category works in practice so that the lower risk faced by insurers with long-term products and related equity investments is correctly captured and barriers against investing in the real economy are reduced. Care must be taken in this area (and in fact all areas) to avoid so many or so constraining criteria that results, as can be seen with the example of duration-based equity module, in nil or almost nil application in practice. In fact, equity under Solvency II has been under various reviews in recent years (eg infrastructure equity, unlisted equity, long-term equity, equity held in specific collective investments). Today there is no clear analysis on the extent to which these sub-classes of equity have found a practical implementation that ultimately achieves the goals that were intended by the legislators, namely to remove barriers to investment by applying excessively high capital requirements.

The industry does not support changes to the existing <u>transitional measures or new restrictions on their application</u>.

[2] Shadow SCR means requiring insurers to test solvency without VA, MA and transitional measures and stressed extrapolation parameters of a 50 year LLP and a 1% reduction in the UFR

Section 2.2 Extrapolation of risk-free interest rates

Q2.1: What is your view on the options on the last liquid point for the euro (including the alternative extrapolation method) set out in this section?

The industry supports no change to the current extrapolation parameters or methodology ie option 1. EIOPA's analysis of the residual volume criterion and the matching criterion demonstrate that market conditions have not changed sufficiently to justify an extension of the LLP.

The industry firmly believes that the existing criterion governing the LLP (ie the bond criterion) must be maintained. Solely relying on the swap market is inappropriate and dangerous. For some undertakings hedging using derivatives is only possible to a limited extent for legal reasons. Furthermore, it is questionable if a significant part of insurers' liabilities could actually be hedged by swaps at the market. Moreover, the cancellation of the bond criterion would increase the volatility of provisions and therefore the procyclicality of life insurance business.

The industry strongly opposes EIOPA's proposal to create a shadow SCR that would require undertakings to achieve full solvency under the assumption of a 50-year LLP (option 2/3/5), UFR reduced by 100 basis points and the removal of the VA/MA and transitional measures. This would de facto override the actual pillar I regulations for the LLP and is to be strictly rejected. It would have very significant implications for the functioning of the insurance sector including increased cost of funding and therefore costs to policyholders. It would also accelerate the decline in the provision of long-term guaranteed products. (See Section 2.7 for further industry views on the creation of a shadow SCR).

In particular, it is both unnecessary and unjustified 1) to provide the additional supervisory powers to limit or withhold capital distributions, as this introduces a new threshold above the SCR; 2) to in disclose it in the SFCR.

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on LTG measures</u>

- Paragraph 26: This paragraph mentions the earlier report from the European Systemic Risk Board. This analysis is incomplete since their justification for a higher LLP is only based on the liquidity of swaps and not of bonds.
- Paragraph 28: The industry agrees that any implications of the LLP need to be considered jointly with the setting of the UFR. As well known (and also mentioned in paragraph 2.37), EIOPA's methodology to calculate the UFR will result in a reduction in the UFR in the coming years. This must be considered in a true holistic impact assessment. In order to be a long-term equilibrium, the UFR must take into consideration the term premium component of market interest rates. Our calculations show that the UFR is currently understated by 1% due to the exclusion of a term premium.
- Paragraph 35: Any deterioration in the solvency position of an insurer which may materialise due to differences between observed market rates and extrapolated rates might take many years to manifest. During this time, insurers will have earned excess returns on their assets which are not accounted for in the current balance sheet but will provide an offsetting effect. Most insurers with very long liabilities are running off legacy portfolios of capital-intensive products. The release of the risk margin and of tied up capital will provide further offsetting effects.
- Paragraph 42: EIOPA has not provided any evidence that the current framework has led insurance companies in Europe to inadequate management decisions due inappropriate risk management incentives. The assessment from EIOPA appears to be to a large extent theoretical. Insurance companies typically consider several metrics when managing interest rate risk (as confirmed by EIOPA's analysis of the BIS study, discussed in paragraph 51). It is also unclear why insurance companies should focus on own funds while most external stakeholders focus on solvency ratio. Options 3,4 and 5 will reduce the solvency ratio and will therefore increase the focus on managing this ratio. Hence, these options are unlikely to meet EIOPA's objectives.

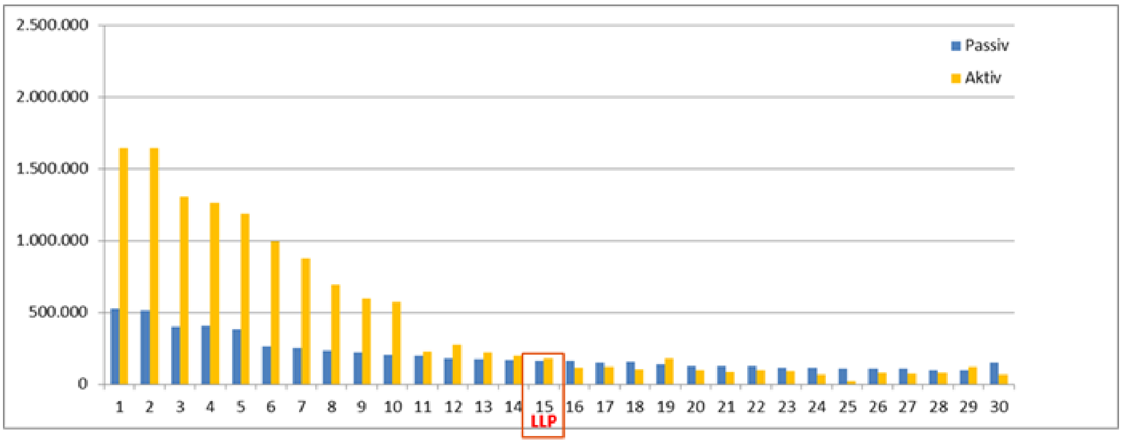
- Paragraph 43: It is not feasible for all insurers to match their risk reflected in the solvency risk balance sheet using derivatives. For some undertakings, hedging by means of derivatives is only possible to a limited extent because, for example, collateral must be provided which is no longer eligible for the security funds ("Sicherungsvermögen") prescribed by national law at least in Germany. In addition, hedging with derivatives is not straightforward (especially for smaller insurers). Using derivatives requires expertise and an adequate (and costly) infrastructure.
- Replacing a significant part of insurers' bond investments with receiver swaps means that banks acting as counterparties will have to enter into huge amounts of payer swaps. Even if banks were able to hedge most of this exposure, this may increase the interdependency between insurers and banks. This is especially the case in times of financial stress, which is not separately evaluated since the DLT assessment of swaps is based on average trade volumes for centrally cleared swaps, which do not have long history. Furthermore, the trade that exists in swaps for longer maturities is only present for a few concentrated exposures, which do not justify an assessment of the interest rate curve as a whole liquid for the maturities in options 3-5. The concentrated exposures will not be sufficient to structure detailed cash-flow hedges that match the characteristics of insurance cash-flows.
- Paragraph 46-47: The industry notes that only one NSA has made any observation about the impact on risk management incentives. It is also worthwhile noting that an insurer who had implemented a market-rates based hedging programme would have benefitted significantly over the past few years as interest rates have decreased.
- Experience in the Netherlands has illustrated what the impact on ALM/capital markets can be from changes in the regulatory parameters, such as the LLP. Dutch life insurers have reported that over the summer of 2019, the Dutch regulator's adjustment to the pension fund yield curve put pressure on the ALM for pension funds. This created contagion as other European insurers followed suit in the expectation of lower rates. All in all, this had a pro-cyclical effect and was one of the decisive factors for the negative development of interest rates in August 2019.
- Paragraph 52: Providing consumers with long-term guarantees should not implicitly be called into question but supported by appropriate regulation. This was also the clear objective of the European legislator.
- Paragraph 53-80: The industry supports the use of the DLT assessment, Matching Criterion and Residual Volume Criterion in the assessment of the LLP and highlights the following:
  - In its Call for Advice, the EC requested that EIOPA should provide evidence of the on the value of the last liquid point <u>in accordance with the DLT, Matching and Residual Volume Criterion</u>. EIOPA's presented Options 3-5 are not in accordance with these criteria.
  - EIOPA has not provided a DLT assessment for Euro bond markets and for bond markets in non-euro countries, despite this being a specific request of the EC in its Call for Advice.
  - The statement that the swap market is DLT for several maturities above the current LLP is only based on 2016 and 2017 data, whereas the Call for Advice stated that this evidence needs to be provided "at the very least for 2016-2018". The chosen threshold (50 M€ daily volume) also seems too low. It is stated that the same thresholds as those proposed by ESMA for assessing MiFiD 2 liquidity have been applied, but no justification is given why these thresholds also apply here.
  - EIOPA's assessment shows that under the matching criterion, the EUR LLP should be lower than the current 20 years. Additionally, insurers are not the only participants in the bond market, so not all bonds are available for insurers to match cash flows from (re)insurance obligations, whereas matching by derivatives/swaps may be limited (see comment on Paragraph 43). Therefore, increasing the LLP may cause a situation whereby (re)insurers would not be able to match their liability cash flows with: (1) cash flows from bonds (as the volume of cash flows from bonds is lower than the volume of cash flows from their liabilities, and other financial institutions also invest in bonds); or (2) derivatives/swaps (as there are some restrictions). For this reason, the Matching Criterion is very important for determining the LLP.
  - EIOPA's assessment shows that under the residual volume criterion, the EUR LLP should be 22 years (based on 2018 data).

- Paragraph 73: The data in this analysis is incomplete. Therefore, the concluded LLP in 2018 excluding unit-linked business of 23 years is misleading especially since the LLP for all cash-flows has not changed from 2017 to 2018.
  The liquidity analysis for swaps is inconclusive. No evidence is provided that a notional amount of EUR 50mn daily trading volume is sufficient to serve the European insurance and pension industries. Further, there is no analysis on the liquidity in times of stress and the structure of the market (number and type of suppliers). There is also no discussion how insurance companies can construct efficient hedges while the swap market is illiquid for most maturities beyond year 12, according to EIOPA's own analysis.
- Paragraph 79: There is not a sufficiently deep and liquid market for swaps in Poland and Hungary to justify a change to the basis for the RFR of these countries. Changing the source of risk-free interest rates from government bonds to swap rates for HUF and PLN will significantly increase the level (in the case of HUF) and volatility (in the case of HUF and PLN) of technical provisions.
- Paragraph 82: Additional restrictions to distribute dividends will increase the cost of funding. This will make it more difficult to raise capital in times of stress reducing policyholder protection. It is unclear how this will resolve the issues identified by EIOPA.
- Paragraph 90-94: The new alternative extrapolation method will also have consequences for the non-Euro currencies. The industry does not agree with the statement that the difference between the new and old (Smith-Wilson) for non-euro currencies, for example the Swedish krona are negligible (see paragraph 2.106 and graph on page 791), even though the LLP coincides with the FSP for most of these currencies. An extensive analysis of this method is required for the non-euro currencies, including for different levels of interest rates.
- The industry notes that the alternative extrapolation methodology would make use of data beyond the 20-year LLP for the Euro. This proposal therefore creates the same issues with the inability of insurers to cashflow match as EIOPA's proposals to extend the LLP to 30 years or 50 years. **As noted above, the industry believes a prerequisite of the extrapolation framework is that insurers are able to match cashflows in the "liquid" part of the curve with cashflows from bonds. For any proposal to be acceptable to industry, it must reflect this principle**.
- The industry also highlights that there are other alternative extrapolation methodologies which may provide similar risk management benefits to the proposed methodology.
- Paragraph 108-113: The extent of any under/over reserving can only be properly assessed after the liabilities have been settled and the actual risk-free rates which are earned on the assets can be assessed. As EIOPA has noted, in addition to the risk-free rates, where insurers earn sufficient returns in excess of risk-free there will be no under reserving. Moreover, EIOPA's own analysis of transfer values does not give rise to the concern of under reserving (see EIOPA's report on ALM, December 2019).

Alternative analysis of EIOPA's figures on the matching criterion/residual volume criterion
The industry has conducted an alternative analysis which clearly shows that the matching criterion results in an LLP of 15. A summary of this analysis is included below.

- The bond cash flows used in the matching criterion analysis assume implicitly that all outstanding bonds could be purchased by insurers. However, in practice, insurers will not be able to purchase all outstanding bonds because of 1) the ECB's asset purchase programme (which has been restarted this year) and 2) competition from other market participants. From industry's point of view, at least a correction for the ECB's asset purchase programme is required in the analysis, as those bonds are not available for purchase anymore. As detailed information on the maturity distribution of the ECB's holdings is not available, the following method has been used:
  - Calculate the total notional volume of the ECB's holdings (excluding asset-backed securities) using figures provided by the ECB
  - This value has been divided by the total nominal bond amount outstanding (based on the iBoxx EUR overall index)
  - The bond cash flows (excluding UL/IL) for 2018 presented in annex 2.4, p. 775, of the consultation paper have then been reduced by this percentage (26%)

- After applying the matching criterion with the corrected bond cash flows, liability cash flows will exceed bond cash flows from the year 16 onwards (with the exception of year 19).



- As the surplus in year 19 cannot be used to compensate earlier deficits, this would result in an LLP of 15 years, significantly lower than the value of 23 years resulting from EIOPA's analysis.

- Additionally, current trends will put further pressure on the LLP resulting from an application of the matching criterion:
  - The ECB's asset purchase programme will continue for an undetermined amount of time
  - Technical provisions will increase as a result of demographic developments and the resulting increase in demand for private pensions
  - Fewer (almost) risk-free bonds are available

- Industry also considers that EIOPA's application of the residual volume criterion is not sufficient. A more detailed view of this criterion, which also takes into account the worsening of credit quality and overall availability of bonds, points towards a lower LLP.
  - As an outcome of the financial and Euro crisis, the credit quality of sovereign and corporate debt has worsened. As a consequence, the proportion of long-term, high-quality bonds (which are generally insurers' preferred investments) to total notional volume has fallen significantly compared to 2019. This is mostly due to the ECB's asset purchase programme. Total nominal outstanding of AAA- and AA-rated bonds has fallen by 8% compared to 2014, and total nominal outstanding of AAA-rated bonds has fallen by 26% compared to 2014.
  - Consequently, the residual volume criterion would lead to a lower LLP when considering just investment-grade bonds net of ECB purchases: the proportion of investment-grade bonds with maturities of 20 years or higher has fallen from 6.4% to 5.2% between 2014 and 2019, leading to an LLP below 20 years.
  - A further restriction on credit quality shows that the availability of high-rated bonds has fallen disproportionately: the proportion of AAA- and AA-rated bonds with maturities of 20 years or higher has fallen from 4.3% to 3.5% between 2014 and 2019, and the proportion of AAA-rated bonds with maturities of 20 years or higher has fallen from 2.3% to 1.1% between 2014 and 2019.

- Life insurers and pension funds hold long-term bonds to maturity to match liability cash flows. The longer the maturity, the higher the portion of buy-and-hold exposure. When rates fall, more and more investors start to chase the same few bonds that are still available. Put differently: liquidity diminishes in scenarios and maturities where it is most needed. The situation will even worsen significantly in times of rising risk aversion (eg. during recessions or periods of high political uncertainty), when "flight to quality" leads to a situation in which even investors with shorter investment horizons start to purchase long-term high-quality bonds. As a consequence, the risk of escalated market volatility and hence volatility in solvency ratios has increased, which again puts at risk the overall stability of financial markets.

Section 2.3 Matching adjustment

- Paragraph 138-165: **The industry supports EIOPA's proposal to remove the restrictions on diversification between MA and non-MA portfolios in the standard formula ie option 2**. It agrees with EIOPA that removing the restriction will:
  - Ensure a level playing field
  - Improve transparency and comparability
  - Avoid unjustified constraints to the availability of long-term guaranteed insurance products and the ability of insurers to make long-term investments (for those insurers who meet MA requirements)

- Paragraph 166-200: **Industry welcomes EIOPA's recognition that firms may undertake certain risk transformation transactions (such as securitisations) in order to obtain a portfolio of MA-eligible assets. However, EIOPA's proposed look-through approach to assessing the suitability of restructured assets to be included in Matching Adjustment portfolios is unduly restrictive and the actual degree to which the underlying assets need to be coherent with eligibility criteria is not clear.**
  - EIOPA should consider placing greater focus on the suitability and robustness of the cash flows associated with the securitisation structure. This approach has already demonstrated its appropriateness in markets where securitisation has been used to include otherwise ineligible assets inside Matching Adjustment portfolios.
  - The main prudential focus should be on the cash flows of the MA eligible notes, rather than on the securitisation structure and the nature of the underlying assets. Therefore, it should be an undertaking's responsibility to demonstrate that sufficient reliance can be placed on restructuring arrangements to ensure the continuing satisfaction of the MA eligibility conditions.
  - Where securitised assets have been externally rated by an approved credit rating agency, the ability to provide a predictable stream of cash flows has been assessed and established, so no further examination of the structure should be required. For other securitisations, the focus of assurance should be on the security of the structure and the certainty of the cash flows of the structure's senior, Matching Adjustment eligible notes. The industry asks EIOPA to reconsider its proposals for a look-through approach that examines the fixity of the underlying assets' cash flows, in favour of one that concentrates on the ability of the structure as a whole to support the senior notes.
  - Additionally, some topics in MA asset eligibility remain unclear, such as the interpretation of the principle of "sufficient compensation" with regards to certain increasingly common bond provisions such as make-whole clauses, 3-month or 6-month call provisions, or calls in the event of a major change in tax law.

- **The industry supports the limited and targeted extension of materiality thresholds within the MA criteria to enable inclusion of certain long-term products, such as certain types of workers compensation and PEPP-like products**. These products would otherwise meet all the requirements and criteria of the MA and without MA eligibility, these products become uneconomical, and as such are likely to be prohibitively expensive for policyholders. These changes are economically justified and would further remove unnecessary negative impacts for customers in terms of costs, product design and product availability. Such improvements can be made while maintaining rigorous levels of policyholder protection and appropriate risk management incentives.

Section 2.4 Volatility adjustment

Q2.2: Should the calculation of the VA be based on the CF-Freeze approach or the MV-Freeze approach? Please explain your view.

While, EIOPA does raise a valid technical point for very low rated (e.g. CQS 5) bonds during periods of severe stress, it appears that in practice the impact would be immaterial:

- The VA reference portfolio has generally allocated 0% to CQS 5 corporate bonds over the past years. An allocation slightly above 0% for CQS5 corporate bonds only occurred during mid-2018 up to mid-2019 (due most likely to temporary downgrades). Hence, the importance of the difference between the CF-freeze and MV-freeze VA presented in the consultation is overstated.
- For investment grade (or CQS 4) corporate bonds, the impact of the CF-freeze vs. MV-freeze approaches should be minor.
- The proposed CF-Freeze approach ignores the impact of downgrades on the VA at times of stress. During times of stress bonds that are downgraded would increase the weights of lower-rated buckets, offsetting any overshooting resulting from the current approach – potentially resulting in underestimating the VA at times of stress. Unless any proposals are able to recognise this, there should be no change in the current approach.

Q2.3: What is your view on the identified deficiencies of the current VA?

There are two deficiencies recognised by the industry – the VA is overall too low and does not sufficiently mitigate artificial volatility. Therefore, necessary outcomes which should result from any changes to the VA are:

A. There is a general increase in the level of the VA to properly reflect the ability of insurers to earn returns above risk-free rates.

B. The VA provides increased mitigation of artificial balance sheet volatility.

The industry notes that neither EIOPA's Approach 1 nor Approach 2 methodologies would achieve the necessary outcomes which should result from any changes to the VA. The industry supports neither of these approaches as a replacement for the current VA.

The majority of the potential deficiencies of the VA hypothesised by EIOPA are not relevant to the calculation of the value of best-estimate liabilities. Only potential deficiency 3 (Cliff effect of country adjustment) and potential deficiency 1 (undershooting) merit further consideration by EIOPA and are closely linked to outcomes A and B detailed above.

Potential deficiency 1 – under/overshooting effects of the VA

- Undershooting is an important issue. Evidence for this is given in the table in paragraph 2.271. Industry encourages EIOPA to further investigate this aspect. The impact of the restrictive definition of contract boundaries in Solvency II may also create discrepancies between non-life insurer's ALM and the application of the VA.
- Over- and undershooting has different drivers: (a) Excessive deductions in the calculation of the VA such as the application ratio of 65%, (b) differences between the spread / interest rate sensitivity of assets and liabilities e.g. due to duration or size, (c) basis risk arising from mismatches between companies' own asset portfolios and the reference portfolio resulting in a deviation between the individual asset spread and the reference spread.
- EIOPA's analysis shows that the overshooting is very limited in Europe due to the in-force guardrails (average portfolio, risk correction, application ratio, etc.). On the contrary, EIOPA's numbers tend to show that undershooting prevails through Europe.
- It is recognised that the use of representative portfolios enables a relatively simple application of the VA which is consistent across currency areas and is easy to implement and manage. On the other hand, to achieve the industry objective of adequately mitigating artificial balance sheet volatility, it is necessary to

reduce the level of basis risk in the VA although there are number of ways in which this objective could be achieved. EIOPA has not demonstrated the extent to which under/overshooting effects arise from differences in the spread duration of the assets and liabilities. This should be quantified by EIOPA.

Potential deficiency 2 – Application of VA does not take into account illiquidity characteristics of liabilities

- The industry disagrees that the VA has been designed to take into account the illiquidity characteristics of liabilities and does not agree there is a prudential need to introduce liquidity penalties. On the contrary, the first two objectives of the VA identified by EIOPA (1. prevent procyclical behaviour and 2. mitigate exaggerations of bond spreads on own funds) are clearly stated in Recital 32 of the Omnibus II Directive.
- EIOPA's proposed adjustment for illiquidity of liabilities is incorrectly mixing valuation issues with solvency capital issues by including 1 in 200 years events – this is by definition overly conservative and would also be double counting because the 1 in 200 scenarios are already covered by the SCR calculations (eg Mass Lapse risk), while there is also considerable prudence in the use of a 65% application ratio..
- The existing VA provisions require companies to prepare a liquidity plan and to demonstrate they are not exposed to forced sales. These provide sufficient evidence that the liquidity profile allows the VA to be earned.

Potential deficiency 3 – Cliff effect of country specific increase

- The industry strongly agrees with EIOPA's assessment that the activation criteria for the country specific increase creates undesirable cliff effects which have proven to introduce artificial balance sheet volatility.
- The inefficient working of the national market component has been evidenced by experience of the Italian market during 2018.
- The industry also agrees that the lack of activation of the country component can result in undershooting effects which prevents the VA in achieving its intended objective as a countercyclical measure.

Potential deficiency 4 – Misestimation of the risk correction

- Industry strongly opposes EIOPA's assessment that the risk corrections are misestimated.
- The risk corrections should reflect the expected economic cost of downgrades and defaults over the long-term and should be based on **long-term default statistics**. It is therefore natural that the risk corrections are largely insensitive to changes in credit spreads.
- The objective of the VA to mitigate "exaggeration of bond spreads" requires a reference point to measure "exaggeration" in the context of the insurance business model. Assets backing insurance portfolios that result in stable cash outflows are not subject to forced selling and therefore all components of the spread, except for the spread relating to expected defaults, can be earned by the insurer in such cases. The asset loss compensation resulting from the VA for such portfolios should therefore include all spread components except the default component. Unexpected default losses are be covered by capital requirements (in the spread risk module).
- Academia does not support EIOPA's hypothesis that the level of the spread is linked to the default rate. In fact, the study mentioned by EIOPA (Giesecke et al. 2010, page 3) as justification for this actually states that "We find that …corporate credit spreads have no predictive power for default rates. These results complement and extend Collin-Dufresne, Goldstein, and Martin (2001), Elton, Gruber, Agrawal, and Mann (2001), Schaefer and Strobilaev (2008), and others who also find that credit spreads are significantly influenced by factors that are difficult to link to credit fundamentals".

Potential deficiency 5 – VA almost always positive

- EIOPA is concerned that overstated VA spreads will tempt insurers to invest in riskier, higher-yielding assets, in order to ensure they continue to earn a spread more than or equal to that implied by the VA. However, firstly this theoretical issue already exists even if there is no VA, secondly searching for yield is not in itself wrong as long as it is based on appropriate ALM, risk/return considerations and risk appetites and thirdly insurance companies have a duty to seek out the good risk/return optimisation on behalf of their customers and shareholders, especially in the current low yield environment. Hence, the design of the VA does not by itself create any additional risks, so this deficiency should be disregarded.

- The VA is not only a mechanism to mitigate artificial balance sheet volatility but also an adjustment to the risk-free rate curve that represents the additional returns that long-term investors can and do earn. Against this background, it is expected to be positive where credit spreads are positive. This objective should be clarified in the SII directive. Furthermore, the VA can be negative even when bond spreads are positive due to the prudent floors already present in the fundamental spreads.
- If credit spreads in the market are negative, this should be recognized in the calculation of the VA to reflect the economics of the long-term insurance business model. However, in the scenario where spreads are low and depressed, as described in 2.294 any "search for yield" behaviour should be assessed as to whether there are heightened risks under the insurance business model. The fundamental credit quality of assets is already considered through the risk correction (for default losses), while other risks such as a sudden "increase in market spreads" (and corresponding price drops) are not relevant where assets need not be sold, and where the material risk is default, which is then already reflected in risk correction and capital requirements (unexpected default).

Potential deficiency 6 – underlying assumptions of the VA are unclear

- The industry supports that both desired outcomes A and B are also clarified as objectives of the VA in the directive ie to represent the additional returns, above risk free rates, that insurers as long-term investors can and do earn and to mitigate artificial balance sheet volatility.
- Industry notes that EIOPA has proposed to alter the requirement to conduct a sensitivity analysis of the assumptions underlying the VA as part of its proposals in section 2.7. This deficiency is therefore no longer relevant.

Potential deficiency 7 – risk-free interest rates with VA are not market consistent

- The industry disagrees that the VA-adjusted risk-free rates are not market consistent. As noted by EIOPA, insurance liabilities are not sufficiently standardised and frequently enough traded to obtain a definite value in the market. Therefore, the value of insurance liabilities is not directly observable on the basis of transactions. A valuation based on discounted cash flows has to adequately consider the characteristics of these cash flows and, thus, to apply appropriately adjusted risk-free rates ie reflect that with stable long-term liabilities, there is no exposure to forced asset sales and therefore considerations around valuation and risk capital can focus on expected defaults (risk correction) and unexpected default (capital).
- Until Solvency II there was no agreed methodology for calculating a risk margin and one had to be developed. There was also no agreed methodology for how to take into account the characteristics of insurers' cashflows described above and therefore the VA and MA methodologies have been developed for Solvency II.
- The wide use of the VA in the market-consistent balance sheet of insurers and similar spread adjustments used in other, similar frameworks (e.g. Market Consistent Embedded Valuation) that also form the basis of M&A transactions indicate that RFR+VA/MA is arguably the best possible representation of a market-consistent valuation for insurance liabilities in the Solvency II framework that are valued on this basis.

Q2.4: What is your view on this deficiency of the country-specific component of the VA? How should it be addressed? (You may want to take into account in particular the options 1, 7 and 8 set out in the following section.)

As noted above, industry agrees that the current design of the country-specific component is deficient. This is strongly linked to desired outcome B – the VA does not adequately mitigate artificial balance sheet volatility – and must be resolved in the review of Solvency II.

The use of an own-assets approach, calculated with a sufficient level of granularity, would significantly reduce the basis risk inherent in the current design of the VA and, as noted by EIOPA, remove the need for a country specific VA. However, it is worth highlighting that **industry does not support option 1 in its current formulation**, largely because it does not agree with changing the risk corrections to be a % of the prevailing spread (see comments above/below). Furthermore, this approach introduces additional complexity in the VA that may only be acceptable if it comes with significant benefits such as overall reduction

in the prudence in the current VA and improvements in risk management incentives that lead to a visible reduction in basis risk. As certain asset classes are not adequately reflected in the proposed own asset approach (ie Dutch mortgage loans in the Dutch market), the additional complexity does not pay-out in a visible reduction in basis risk.

EIOPA's option 7 to amend the trigger and the calculation of the country-specific increase of the VA is potentially an improvement on the current criteria and design and would go some way to resolving the deficiency. However, the proposal could be further enhanced through a lower activation component.

An alternative way to implement option 7 would be to change the national market component to an entity-specific component, potentially in a similar vein to what EIOPA has discussed for the macro-VA in paragraph 510.

Industry opposes EIOPA's option 8 to make a clearer split of the VA between its function as a crisis and permanent tool. This proposal would not resolve the deficiencies of the country-specific increase because the design is overly conservative (e.g. 20 bp deduction) and the benefit it provides is reduced too quickly. This is due to i) the activation mechanism (substitutive instead of additive component) and ii) the use of the average historical rates for the computation of the macroprudential component. While the substitutive mechanism has a negative impact on the VA's predictability, the use of average historical rates does not capture prolonged periods of stress or relapses.

As detailed by EIOPA, option 8 changes the reference point for assessing whether spreads represent a crisis or not from the level of the currency VA to the average historical rates in the national market. This reduces its effectiveness as a crisis measure for insurers who continue to be subject to discount rates which are referenced to a currency VA. In addition, the unpredictable nature of the rolling average mechanism can create the situation where countries, which should benefit from the adjustment according to their volatility and spread levels, are not eligible for this relief. Moreover, undesired or failed activations of the macro-component would undermine the VA's ability to limit over/undershooting effects, which was identified by EIOPA as one of main deficiencies of the VA.

Q2.5: What is your view on the safeguards to avoid wrong investment incentives? In particular, how can wrong incentives with regard to investments in government bonds best be avoided?

See comments on Option 1 detailed below.

Q2.6: Should liquidity buffers be recognized in the VA calculation? If yes, please describe how they should be recognized.

See comments on Option 5 detailed below.

Q2.7: What are your views on Approach 1 and Approach 2?
Your comments are also invited on the options that are implemented in Approach 1 and Approach 2 as well as on the other options specified in this section.

Neither Approach 1 nor Approach 2 would achieve the necessary outcomes which should result from any changes to the VA whereas they would bring significant additional complexity. The industry supports neither of these approaches as a replacement for the current VA.

The industry provides views on the different options outlined by EIOPA in the consultation paper below.

Option 1 – undertaking specific VA (aka Own Assets VA)

- It should be highlighted that industry does not support EIOPA's proposed change to the derivation of the risk corrections, neither implicitly as part of option 1 nor explicitly in option 6.
- An Own Assets VA calculated with a sufficient level of granularity, would significantly reduce part of the basis risk inherent in the current design of the VA. It is however crucial that sufficient level of granularity in asset class modelling is present in order to make this option work as well as a company-specific VA. Otherwise a situation can arise whereby large asset holdings must be mapped to asset classes, which do not necessarily represent the characteristics of the holdings (eg. large holdings of residential mortgages in the Dutch sector). In the same vein, there is the need for determining if the weights should be determined at group, entity or portfolio level with no obvious answer.
- Industry acknowledges supervisory concerns about potential wrong risk management incentives. However, industry does not agree with the magnitude of these concerns and notes that a combination of existing safeguards (eg PPP, ORSA) and some of the newly-proposed, VA-specific safeguards could be sufficient to address such concerns. See also earlier comments under Potential deficiency 5.
- However, industry agrees the following safeguards are reasonable in the context of an Own Assets VA
    - Spreads from sub-investment grade corporate bonds are capped at CQS3, which is reasonable as it is consistent with the MA. However, it may also reduce insurer's contribution to the EC's CMU objectives as there would effectively be a penalty for insurers who invest in sub-investment grade bonds and could also potentially disincentivise investments in BBB-investment grade bonds due to the cliff-edge impact of a downgrade.
    - Pillar II requirements – explanation of changes in the asset allocation, a sensitivity analysis referencing the previous year's allocations and a description of the use of the VA in the risk management policy included as part of the ORSA.
    - Pillar III requirements – public disclosure in the SFCR of the asset allocation (at an appropriately high level of granularity) and an explanation of changes in the asset allocation, a sensitivity analysis referencing the previous year's allocations.
    - EIOPA's proposal to grant supervisory powers to impose a VA based on the insurer's previous year's asset allocation should only be available if there was a significant reallocation of assets during the year. In order to prevent opportunistic ALM behaviours, the VA calculation should be based on asset allocations identified on a periodical basis (ie yearly, quarterly, etc.).
- It should also be recognised that a company/entity-specific VA and these additional safeguards would increase the operational burden for all VA users and add complexity compared to the current representative portfolio VA. This would only be justified if it would be accompanied by significant benefits in terms of the current prudent level of the VA and would materially reduce basis risk.

Option 4 – Adjustment accounting for amount of fixed income assets and asset-liability duration mismatch

- The current approach of assuming equities and property earn a zero spread above risk free and for this assumption to have a major impact, reducing the VA significantly, is not economically correct or appropriate. It contributes to an unacceptably low VA.
- Therefore, rescaling of the fixed income portion of the reference portfolio to be 100% of the portfolio is a welcome development. This is one possible approach to achieving the desired objective A: increasing the level of the VA to better reflect the additional returns that insurers can and do earn above the risk-free rate, and to some extent objective B.
- Other changes that should also be considered are a) remove pure unit-linked business from the reference portfolio and b) to leave the scaling as it is but (to recognise that equities and property assets within the reference portfolio have always, and will, on average earn a return above risk free) include a reasonable estimate of equity and property returns into the calculations of the VA.
- This development should not be limited to the calculation of any currency VA but also extended to the national market component.

- The retention of the 65% general application ratio is not consistent with this proposal. Therefore, if this proposal is to be taken forward as a potential change, then the general application ratio of 65% must be removed. Please also refer to comments on the General Application Ratio under question 2.8.
- The industry further notes that the proposed calculation of the duration ratio does not properly take the impact of the existing 65% GAR into account. This is because it implicitly assumes the spread sensitivities of the BEL and the assets are consistent, which they are not due to the 65% GAR.

Option 5 – Adjustment accounting for the illiquidity of liabilities

- Industry does not agree that there is a prudential need to introduce liquidity penalties into the calculation of the VA.
- EIOPA's preferred approach, Approach A, is to derive this "illiquidity factor" by comparing the baseline cashflows with cashflows derived under various standard formula SCR stresses, eg mass lapse. The 1-in-200 year event is far too conservative to cast doubt on illiquidity and inappropriately mixes and double-counts solvency capital elements with valuation. However, referring to difficult-to measure incentives and theoretical termination options that hardly play a role in practice (Approach B) would be even worse.
- The proposed change would cause a huge and unjustified increase in complexity: it requires eight prior calculations (with two sets of stochastic scenarios where relevant) of the best estimate between the final one (which means one additional calculation and one additional generation of stochastic scenarios) and introduces different volatility adjustments for different entities in a group.
- Insurers are already required to have liquidity management and to regularly assess the possible effect of a forced sale of assets in place in order to apply the VA.
- The proposal to introduce Reporting on Liquidity buffers is a more proportionate and sensible approach to addressing supervisory concerns about liquidity related to the use of the VA.

Option 6 – risk correction calculated as a percentage of the spread

- Industry strongly opposes EIOPA's hypothesis that the risk correction is misestimated and strongly opposes the option to calculate the risk correction as a percentage of the prevailing spread.
- The changes in option 6 would undermine the anti-cyclical effect of the VA. The industry asks EIOPA to present strong evidence that this is would not be not the case.
- The risk correction should reflect the expected cost of default and downgrade ie a realistic assessment of the long-term costs incurred by holding a diversified portfolio of bonds over the long-term. As such, this should be based on historical average default statistics.
- The current methodology to derive the risk corrections already contains a margin for prudence relative to the true expected default costs for corporate bonds due to the long-term average spread underpin.
- Unexpected credit risk is included in the SCR for spread risk and references to this should be removed from Article 77d. As the other risks of the assets are included in the SCR, option 6 leads to double counting of risks between the valuation and capital requirements.
- The literature referred to in the consultation paper (p. 135-140) is based on theoretical models and their practical use under Solvency II is not very clear. Webber (2007), Feldhütter et al. (2012), Van Loon (2017) and others are based on a Merton structural model or regressions linked to bid-ask spreads; such approaches are rather theoretical and do not provide sufficient insight into the yields that insurers can obtain by holding their assets until maturity.
- A practical view on the illiquidity premium may simply be to compare actual spreads to realized default losses (or currently stable risk corrections); this approach would be relevant for insurers' realised cash flows and would often lead to higher illiquidity premia compared to academic literature.

Academic literature on the relationship between the credit spread and expected losses

- Despite EIOPA's statements to the contrary, EIOPA's hypothesis that expected losses are linked to the level of the prevailing spread does not seem to be unanimously supported.

- According to Amato and Remolona (2003)[3], for corporate bonds, expected loss accounts for only a small fraction of spreads across all rating categories and maturities. They also state that "In general, spreads magnify expected losses, but the relationship is not one of simple proportions" and that "a more relevant feature of the relationship between spreads and expected losses is that the difference between them increases in absolute terms as the credit rating declines."
- Alexopoulou et al. (2009)[4] decompose the observed credit spreads into the expected losses and the risk premium. They proxy the market's perceived default risk by one-year-ahead expected default frequencies (EDF) provided by Moody's. By assuming a 40% recovery value (a standard assumption in literature) they derive the risk premium as the absolute difference between the observed level of CDS spreads and the expected loss.
- Figures 1 and 2 reported below[5] show this decomposition for the financial and the non-financial sample:

Figure 1: Financial

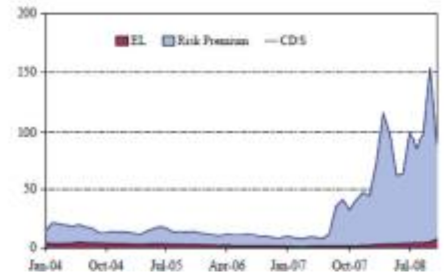
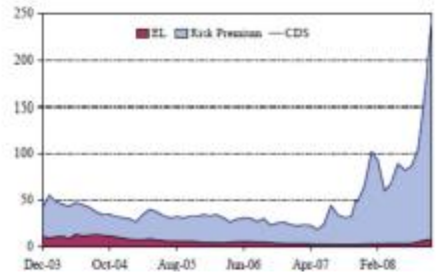


Figure 2: Non financial



- As stated by the authors "Two main features may be inferred from these decompositions. First, up until the turmoil got underway in the summer of 2007, both expected losses and the demanded risk premium hovered at relatively low levels (for both financial and non-financial CDS spreads). Second, the bulk of the sharp upturn in perceived credit risk since August 2007 seems to reflect a higher compensation".
- Fischer and Stolper (2019)[6], using data for the 2004-2016 period, find empirical evidence for corporate bond prices to be primarily driven by credit risk and interest rate risk during quiet market conditions. During more anxious and volatile markets, however, the impact of these two factors abates, whereas liquidity risk becomes the salient issue. While representing a negligible factor during calm phases, market-wide illiquidity shocks appear to result in substantial and long-lived increases in risk premia on the corporate bond market when a bearish sentiment prevails. This considerable impact of illiquidity on corporate bond spreads has not been reported previously by similar empirical studies based on simpler models. The results – which are shown to be robust against various modifications of the model setup – suggest that in highly unstable times - like the global financial crisis - liquidity risk may supersede credit risk as the most important determinant of corporate bond spreads.

- From a VA perspective, the main findings coming from the papers described above are the following:
  - The risk correction must be calculated as an absolute value and not as a percentage of the spread;
  - The portion of the spread reflecting credit risk fundamentals appears significantly less volatile than the entire spread;

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[3] Amato J.D. and Remolona E. M. The credit spread puzzle. Bank for International Settlements. BIS Quarterly Review, December 2003.

[4] Alexopoulou I., Andersson M., Georgescu O. M. An empirical study on the decoupling movements between corporate bond and CDS spreads. European Central Bank (ECB). Working paper series n. 1085 / August 2009.

[5] Alexopoulou et al. (2009), figure 3a and 3b, page 22.

[6] Fischer H. and Stolper O. (2019). The nonlinear dynamics of corporate bond spreads: Regime-dependent effects of their determinants. Discussion Paper. Deutsche Bundesbank N. 08/2019.

- Under stressed market conditions, where the need for an effective VA increases, liquidity risk is the main determinant of the credit spread movements. This confirms that assuming risk correction that moves linearly with respect to the credit spread is not economically justified.

Consistency between the risk correction and fundamental spread

- According to Solvency II regulation, the manner in which the risk correction for the VA and the fundamental spread for the MA are calculated should be the same. In particular:
  - 1) Omnibus II Directive states that "In view of the importance of discounting for the calculation of technical provisions, Directive 2009/138/EC should ensure uniform conditions for the choice of discount rates by insurance and reinsurance undertakings. In order to ensure such uniform conditions, implementing powers should be conferred on the Commission to lay down relevant risk-free interest rate term structures to calculate the best estimate, fundamental spreads for the calculation of the matching adjustment and of the volatility adjustments."
  - 2) Article 52 of the Delegated Regulation states that "The portion of the average currency spread that is attributable to a realistic assessment of expected losses, unexpected credit risk or any other risk referred to in Article 77d(3) and (4) of Directive 2009/138/EC shall be calculated in the same manner as the fundamental spread referred to in Article 77c (2) of Directive 2009/138/EC and Article 54 of this Regulation."
  - 3) Looking at the Technical documentation of the methodology to derive EIOPA's risk-free interest rate term structures, EIOPA, at paragraph 30, states that "EIOPA understands that the intention of the phrase 'in the same manner' in Article 51 is to cover all the elements of the calculation, including the data underlying it. This means that the same approach should be applied for both the risk correction and the fundamental spread. In particular, EIOPA has not used different market default and transition inputs for these calculations."
- In paragraph 2.170, EIOPA notes that its "LTG reports have assessed the losses in MA portfolios compared against the fundamental spread provisions. Every year it has been observed that the fundamental spread significantly exceeds the losses from default and downgrade within those portfolios, indicating that undertakings are earning the MA as expected, arising from the assets held. This provides some reassurance that the measure is operating as expected."
- It is not fully clear why EIOPA have assessed the fundamental spread to be working well but the risk correction, which is intended to be a consistent measure for the VA, to require significant changes.

Option 7 – Amend the trigger and the calculation of country-specific increase in the VA

- **EIOPA's option 7** to amend the trigger and the calculation of the country-specific increase of the VA is potentially an improvement on the current criteria and design and would go some way to resolving the deficiency. However, the proposal could be further enhanced through a lower activation component.
- An alternative way to implement option 7 would be change the national market component to an entity-specific component, potentially in a similar vein to what EIOPA has discussed for the macro-VA in paragraph 510
- There are several merits to this approach:
  - it is simple in its application;
  - it allows to improve the recognition of national specific crises;
  - the smoothing mechanism mitigates the cliff edge effects (identified by EIOPA as "Potential Deficiency 3") which can introduce artificial balance sheet volatility for undertakings located in countries experiencing a crisis. This has been clearly evidenced by the situation of the Italian insurance market during 2018;
  - it improves efficiency in the risk management process, since it eliminates non- linearity and uncertainty in the evaluation of liabilities;
  - as stated by EIOPA, it mitigates undershooting effects, as the level of the technical provisions is more consistent with the asset side of the balance sheet, consistently with undertaking's ALM practices.
- See also comments under Q2.4

Option 8 – Clearer split of the VA between its function as a crisis and permanent tool

- Industry opposes EIOPA's option 8 to make a clearer split of the VA between its function as a crisis and permanent tool. See comments under Q2.4 for further details.

Operational considerations regarding Approach 1 and Approach 2

In addition to the above comments on the specific options discussed by EIOPA, the industry highlights that there are a number of operational issues to consider.

- Although only approach 2 is called 'undertaking specific', both approaches lead to an entity-specific VA.
- For small and medium-size undertakings it is potentially a heavy burden to determine the application ratios on a regular basis: up to now it is possible to create stochastic scenarios with and without volatility adjustment in parallel, performing BEL calculations both with and w/o VA directly after. With the suggested approaches this will not be possible anymore. The calculations for BEL must be final w/o VA, then a 'preliminary' VA must be determined, probably stochastic scenarios with this preliminary VA need to be created, with a BEL calculation afterwards in order to determine the duration application ratio. Only then the final VA stochastic scenarios can be created and final BEL calculation with VA can be executed.
- For insurance groups an additional issue can occur: the creation of stochastic scenarios is often centralized in order to reduce workload and complexity. In case every company in the group needs individual stochastic scenarios, this would increase complexity and calculation/reporting timelines.
- For insurance groups with internal models another issue will be that aggregation of risk capital on group level might become significantly more complex in case various different levels of a volatility adjustment are applied.
- In order to reduce part of this complexity, it would be necessary to keep these application ratios constant during the year and only updated for year-end calculations.

Q2.8: What is your view on the general application ratio? Should it be changed in case approach 1 or approach 2 to the VA design would be adopted?

As noted by EIOPA, the application ratio was introduced to deal with several perceived risks relating to the implementation of the VA. EIOPA's original 20% calibration is irrelevant. It was a relic from historical and rejected ideas on the Counter Cyclical Premium (CCP), was not based on theoretical or analytical justification and, if it had been implemented, would have rendered the VA completely ineffective.

The 65% was the result of a political negotiation and although the calibration remains technically unjustified, it is generally accepted that the 35% haircut reflects a number of residual risks relating to the VA including ALM mismatch and liquidity risk and that this adjustment is very prudent (arguably any ratio below 100% can be considered prudent as the spread calculated on the European reference portfolio already reflects the best estimate spread). In the consultation paper, EIOPA has proposed solutions to identify and tackle explicitly such risks (ie Option 4 and 5) but has not proposed to remove the 65% GAR, noting the unidentified and unassessed operational difficulties which would characterize the proposed approaches. EIOPA's justification to retain the 65% GAR is very weak from a technical point of view and considered unacceptable from an industry perspective because i) EIOPA itself has proposed the more complex mechanisms, and ii) the two approaches do not bear the same level of complexity from a calculation perspective.

According to EIOPA's figure, 65% is already very efficient and prevents overshooting effects from undermining the VA framework in terms of prudency. Even more, it is so conservative that the European insurers using the VA generally face an undershooting effect. The application ratio therefore could be relaxed without endangering policyholder protection and make the VA even more efficient and effective in tackling procyclicality within the Solvency II framework.

On the other hand, retaining a general application ratio of 65% while adding additional further downwards adjustments resulting from considerations of fixed income allocation, duration mismatch and illiquidity features results in material double counting of corrections.

Therefore, if any such proposals were to be taken forward as potential changes then the general application ratio of 65% should be removed.

Q2.9: Should the dynamic VA be allowed for in the SCR standard formula? If yes, how should it be implemented?

Yes, industry supports the extension of the dynamic VA to the standard formula. See section 5.2 for more details.

Section 2.5 Dynamic volatility adjustment in internal models

The industry supports the continued application of the Dynamic Volatility Adjustment in internal models. This is a fundamental part of some internal models because by applying changes to both assets and liabilities, it ensures a proper reflection of the movements in own funds in the SCR as required per the Solvency II Directive. For this reason, the industry also supports its extension to the standard formula to resolve the incorrect treatment of the impact of corporate spread movements in Solvency II.

In the Directive 2009/138/EC, Article 105, it is stated that an insurance or reinsurance undertaking has to account for the effects of the scenario on the whole of the economic balance sheet.

"…The market risk module shall reflect the risk arising from the level or volatility of market prices of financial instruments which have an impact upon the value of the assets and liabilities of the undertaking. It shall properly reflect the structural mismatch between assets and liabilities, in particular with respect to the duration thereof. … (d) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure (spread risk); …."

If an insurance or reinsurance undertaking uses the volatility adjustment in accordance with their risk management policy, applying the spread scenario will have the following impact on the economic balance sheet.

Assets
Spread sensitive assets will decrease in value due to the increase of spreads. This will have a increasing effect on the deferred taxes and or actual taxation (subject to local fiscal legislation).

Liabilities
As the spreads increase according to the scenarios applied , the input values of the VA will change. This will increase the value of the VA. The increase of the VA will have an impact on the value of the best estimate. This value will decrease, which in turn will have a increasing effect on the deferred tax liabilities or decrease in the deferred tax assets or actual taxation.

As the capital requirement is the impact of the scenario on the basic own funds, the aggregation of the impact of spread changes on the assets and liabilities is to be determined. In the current practice, the impact on the assets is deemed to resemble the spread risk capital requirement, while the impact in the liabilities is deemed to resemble the dynamic VA.

The resulting capital requirement is consistent with the actual risk profile of the spread sensitive parts of the economic balance sheet and the going concern requirement for the calculations of the economic balance sheet and SCR. This is because unrealised losses arising from changes in credit spreads will only crystallise if the insurer sells the bond at a loss (and not replace it with an equivalent bond) or the issuer defaults. As insurers can avoid forced selling, they are typically concerned about actual losses from defaults. It is default risk which will alter the ability of the insurer to collect the cashflows and pay its planned obligations.

Section 2.6 Transitional measures on the risk-free interest rates and on technical provisions

Industry supports the continued application of the transitional measures as foreseen as in the Directive.

The transitional measures are key elements in the Omnibus II agreement and represent "real capital" as asserted by numerous NSAs. The transitional measures need to remain stable during the run-off period to avoid any negative consequences on long-term business, eg negative impact on profit-sharing. No changes are needed, and there should be no national restrictions on the use of the measures.

The industry does not agree with EIOPA's policy options to increase the public disclosure requirements on the use of the transitional measures. It is not clear what benefit would be derived from the publication of a justification of the use of transitional benefits in SFCRs.

Further, industry does not agree with EIOPA's policy options to restrict the future application of the transitional measures. This could present unreasonable obstacles to M&A and consolidation activity, as it would impact reinsurance transactions that are much more frequent in the market and result in the same economic transfer of risk. It also creates an unlevel playing field compared with companies that already have been granted the use of transitionals. Furthermore, EIOPA acknowledges the macroprudential role of transitionals, which can mitigate "systemic risk" (EIOPA table 11.2).

- Paragraph 718: The impact of the transitionals on the solvency position are already provided. Projections regarding the reduction of the dependence on transitionals rely on various assumptions, expert judgement, thus a deep understanding of the business model. Similar reasoning holds true for the reason to apply the transitional.
- Paragraph 720: An additional capital add-on is not an appropriate instrument in cases where the phasing-in plan provided by undertakings is not feasible anymore. In contrast, it would usually be counterproductive.

Section 2.7 Risk management provisions on LTG measures

The industry strongly opposes EIOPA's proposal to create a shadow SCR that would require undertakings to demonstrate fulfilling of fictitious capital requirements after removal of the VA, MA and transitional measures and with a 50-year LLP and a reduction of 100 basis points in the UFR. This proposal undermines key aspects of the Solvency II framework, such as the SCR and its purpose, without which the functioning of the European insurance industry would be significantly jeopardised. It also not only challenges, but effectively changes, the confidence level of the SII framework, to a level far beyond the current 99.5th percentile. This is in direct contradiction with the explicit request from the European Commission in the Call for Advice.

The LTG measures are economically justified and are designed to support the provision of long-term insurance products and facilitate long term investment. These were introduced in order to ensure an appropriate treatment of insurance products that include long-term guarantees (as stated by EIOPA in the consultation). Limiting capital distributions based on the proposed scenario would counteract these aims. It would also lead to excessive capitalisation of the insurance sector and risk an inefficient use of capital.

- Paragraph 748: Industry supports the removal of the requirement to create a separate liquidity plan when using the VA. The use of the VA can adequately be incorporated into an insurer's wider liquidity risk management plan.
- Paragraph 746-748: Industry supports the proposal to change the requirement on sensitivity analysis of the VA to variable economic conditions rather than variable assumptions (ie option 3). The results of this analysis should remain in the RSR.
- Paragraph 749: Industry supports option 2; the deletion of the requirement on forced asset sales.
- Paragraph 750-751: Industry supports option 3; Clarification that the policy on risk management should include the use of VA.
- Paragraph 752-757: Industry strongly opposes the proposals to replace the current requirement to provide an analysis of the measures restoring the compliance for the MA and VA. It introduces a carve out from what the Solvency II framework is. The current reference point for supervisory intervention is when the SCR calculated with the transitional and LTG measures, including the current UFR, is breached. This proposal would introduce an additional reference level. De facto, this means that intervention will start at coverage ratios higher than 100% of the SCR with LTG measures undermining the purpose of the SCR within the Solvency II framework. In addition, from a risk management perspective, it cannot be assumed that supervisors will be "convinced" by any demonstrations of the undertaking that capital measures "do not put at risk the protection of policyholders...", given that this is a subjective assessment for which EIOPA has not outlined any further criteria. As such, industry disagrees with the advice, which blurs the boundaries between Pillars 1 and 2 of Solvency II, and thereby takes away a significant amount of legal certainty. Further, the consequences of the "shadow SCR" will depend on what is included in "other voluntary capital distributions", which is very unclear in the consultation. Allocated bonuses to the policyholders should not in any way be included in these distributions.
- Paragraph 758: In line with the IAIS requirements (ICP 16.9), we see the need for a liquidity risk management plan only in cases of increased liquidity risks (see comment on 11.144). This is not per se the case for VA users.
- Paragraph 762: Industry opposes the EIOPA proposal to grant NSAs powers to block capital distributions, even though capital requirements are met.

Section 2.8 Disclosure on LTG measures

The industry proposes to remove the requirement to publicly disclose the impact of a MA/VA=zero scenario. The VA and MA are fundamental elements of the SII framework and were introduced in order to ensure an appropriate treatment of insurance products that include long-term guarantees (as stated by EIOPA in the consultation). Requiring companies to disclose the impact of a scenario without the MA or VA is not consistent with the rationale of these measures and conveys the unintended message to the markets that the LTG measures are in some way non-permanent. As this is not the case, the requirement to publicly disclose this information should be removed from the SII framework.

- Paragraph 768: **EIOPA's proposals regarding the public disclosure of the LTG measures are unnecessary and will increase the reporting burden on insurers without any benefit to policyholders/other stakeholders.** The industry notes that NSAs were "generally satisfied with the completeness of the information disclosed" about the use of LTG measures in the SFCRs. The industry recognises that certain stakeholders (consultants, analysts etc.) are generally always interested in additional detail or analysis but notes that there are other ways to ascertain this information. Policyholders are unlikely to be interested in detailed descriptions of the LTG measures.
- Paragraph 797: **The industry strongly opposes the introduction of a requirement to disclose a sensitivity analysis of a 100 bps decrease in the UFR in the SFCR**. This stress scenario is beyond the boundaries of the SII framework, not in line with current UFR methodology where the maximum annual change is equal to 15 bps and therefore provides no value. Where relevant, a sensitivity on the impact of changing the UFR is already included in ORSA.

Section 2.9 Long term and strategic equity investments

The industry is disappointed by EIOPA's work in this area.

EIOPA fails to propose any improvements that would support equity investment and the EC CMU project. The industry appreciates that the framework contains a set of sub-categories for equity, meant to cover the cases where insurers' equity risk exposures are lower. Unfortunately, the qualification criteria for these categories are difficult to apply in practice, which is also acknowledged by EIOPA. However, EIOPA fails to provide solutions to address the challenges.

In general, any assessment about insurers' long-term investment in equities should be done at a portfolio, rather than individual level. Insurers invest in equities for their long-term performance arising from the combination of dividends and capital gains. While equities can exhibit significant short-term price volatility, where insurers can avoid being forced sellers of their equity holdings the actual risk that they face is one of long-term underperformance of the asset and not the instantaneous fall in value. It is the long-term liabilities and the stable resources (including future premiums on a going-concern basis and own funds), combined with flexibility in terms of management actions that allow insurers to avoid being forced sellers. In fact, insurers manage equity investments as part of diversified portfolios of assets including fixed income, property, etc which back liabilities. These assets are bought and managed based on insurers' ALM (asset liability management) strategies, and in line with insurers' risk appetite and internally set investment limits.

The current treatment of equity under Solvency II is therefore not appropriate.

Specifically, in the case of **long-term equity (LTE) investments (Art 171a)**, the very restrictive conditions of Article 171a are hard to fulfil in practice and reduce the practical use of this measure to increase insurers' investments in equities.

- For example, the requirement that the sub-set of equity investment has to be included in a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance obligations corresponding to **clearly identified businesses** is difficult to implement. Similarly, the requirement to **separate the assigned portfolio of assets** from the other activities of the undertaking is also not applicable in practice in many cases where liabilities are generally covered by a cover pool of investments, with no allocation of individual investments to individual liabilities.
- The 5-year limitation on the holding period, as well as the restrictions on selling equity are not appropriate. Although insurers typically have investment policies and strategic asset allocations based on a long-term horizon, it is important to avoid requirements to hold specific equity holdings or equity funds for a minimum number of years, as this effectively imposes a "passive asset management system" without regard to actual risks and performance potential. Instead, the industry suggests that concerns related to exposure to forced sales of assets should be assessed via the ORSA.
- Regarding EIOPA's proposal for a new criterion, there is very limited to **no value in adding a criterion requiring portfolio diversification** for long-term equity. In practice, adding another criterion further increases the complexity of the sub-module and, in reality, the diversification element is already a requirement of the Solvency II prudent person principle.
- Regarding EIOPA's proposal to exclude controlled intra-group investments from the scope of LTE, the industry does not support this change unless the volatility criterion is removed from the strategic equity investments (see below).
- In general, some uncertainty remains regarding the scope of application and the criteria to be satisfied under the LTE sub-category. Guidance and dialogue at NSAs level is needed to ensure that the application of the LTE investments sub-category is duly considered and is workable in practice. As in other cases, the burden of proof should not always lie with the undertakings, but also with the NSAs, and efforts to make the LTE sub-category work should be shared.

Regarding **strategic equity investments (Art 171)**, the industry believes that:

- The lower volatility criterion should be removed. As EIOPA acknowledges, this would reduce complexity for both insurers and supervisors.
- A prescribed beta-method for the volatility criterion in the regulation is not needed, neither as an optional nor as a compulsory method.
- The 20% minimum ownership and control threshold is too high. This should be reduced to 10%.
- The qualifying criteria should be built instead on the strong links between the insurer (ie the participating undertakings) and the investee company (ie the strategic participations), focusing on the long-term holding strategy/ability of the insurer and its strategic commitment in the investee company.

- Paragraph 836: The industry calls on EIOPA to run an analysis on the same basis as the other Solvency II modules, namely measuring the losses and not the losses on excess return on risk-free rates. The choice to use excess returns based on minimum yearly values fails to properly account for long-term equity risks for the multi-year period and assumes that insurers will be forced to dispose of these investments at their lowest value every year. The industry also draws attention to the fact that the analysis is limited by the fact that only listed equity is included, while in the reality non-listed equity should also be included in the assessment.
- Paragraph 870: The industry's preferred option is option 2. The second preferred option is option 1. The industry strongly opposes options 3 and 4, as they could lead to a *de facto* limitation by NSAs in the use of other methods (which some companies are today applying with the agreement of their NSAs).
- Paragraph 871: In the "Con" section for options 3 and 4 the industry proposes to add the following: *Prescribing a method may lead to a de facto limitation of any other methods that insurers have been using so far.*
- Paragraph 877: The industry supports option 4 and it suggests adding in the "Pro" section the following: *A 10% threshold would enhance the scope and use of this category of strategic equity.*
- Paragraph 925: The prudent person principle of Solvency II already includes a diversification requirement. The industry suggests adding in the "Con" section the following "This additional criterion would increase the complexity of the sub-module"
- Paragraph 946: Undertakings and NSAs should agree on a reasonable scope of application for the strategic equity risk charge. However, requiring more quantitative data on the volatility of the value of such participations does not consider that what makes these participations strategic is not their own business, but the purpose of the participating undertaking. The latter deliberately decides that it will not give up the participation in case of stress, which justifies departing from the one year holding period. Hence, quantitative methods won't help to shed light on this issue. Rather, legislation must ensure that the declaration of a participation as strategic means a commitment from the participating undertaking, which needs to be based on actions. One qualitative criterion could be the level of integration in the participating undertaking's business, e.g. the implementation of the group-wide governance system in a strategic participation.
- Paragraph 948: The application of the strategic equity risk charge should be limited to participations in related undertakings, whether they are (re)insurers or not. This should be made more explicit.
- Paragraph 951: As pointed out under 2.946, the decisive element for the lower volatility of the participation is not the participation (related undertaking) itself, but the participating undertaking's aim or plan. Hence, the correlation of the performance with the value is not relevant.
- Paragraph 963: While the concern regarding the inclusion of controlled intra-group participations in the scope of LTE is understandable in theory, the industry does not believe that an exclusion is an adequate measure to achieve that LTE investments are actually held over the long term.
  - This is because LTE investments can be represented by intra-group investments and can often be directly linked to a source of return for policyholders. For insurers who take a long-term strategic view, such intra-group investments are often compliant with the criteria of Art. 171a. Unfortunately, it is more difficult for them to qualify under the strategic equity submodule (Art 171), largely because the condition of lower forward-looking short-term volatility is difficult to demonstrate. Therefore, unless the volatility criterion is removed to allow for proper use of the strategic participation category (Art. 171), the industry advocates against changes in Art. 171a that would exclude intra-group investments.

Q2.10: Should the correlation of risks between the participation and the participating undertaking be taken into account in determining whether a participation can benefit from the lower capital charge for strategic equity investment? Please explain your view.

No, the correlation of risks between the participation and the participating undertaking is of only theoretical use and cannot reasonably be measured in practice. It can thus not be taken into account.

Q2.12: Do you consider that the illiquidity of liabilities (and more broadly the characteristics of insurance business) are reflected in an appropriate manner in the current equity risk sub-module? If the answer is "No", please elaborate on the changes that you deem necessary.

No, the current treatment of equity under Solvency II is not appropriate. In particular, the industry is concerned about EIOPA statements in its report on insurers' asset and liability management in relation to the illiquidity of their liabilities (EIOPA report of December 2018: https://eiopa.europa.eu/Publications/Reports/EIOPA_Report_on_insurers_asset_and_liability_management_Dec2019.pdf). The report claims that insurers are not long-term investors in individual assets and distinguishes between the length of an investment in individual assets and of an investment in an asset class. In this respect, the industry reiterates that the investment horizon of individual assets cannot be the basis to assess insurers' long-term behaviour, as this assumes a passive behaviour by the investor without properly reflecting the real nature of the exposure to investment risk. There are valid instances for selling assets, especially in consideration of insurers' duty towards their customers/shareholders, which do not conflict with insurers' ability to hold equity investments in the long-term.

Section 2.10 Symmetric adjustment to the equity risk charge

Section 2.11 Transitional measure on equity risk

Section 2.12 Extension of the recovery period

3. Technical provisions

Section 3.1 Best Estimate

The industry supports EIOPA's clarification that it is a 'right' rather than an 'obligation' for insurers to perform an assessment at the level of individual contracts, the definition for <u>Future Management Actions</u> and the clarifications made for <u>expenses</u>.

However, the industry disagrees with the changes proposed in relation to the calculation of <u>EPIFP</u>. In addition, the industry does not see the added value of introducing a definition for the gross expected future profit/loss from servicing and management of funds.

Regarding <u>contract boundaries</u>, the industry disagrees with EIOPA's proposal to introduce new requirements. This is an example of harmonising gold-plating of Solvency II.

- Paragraph 46 – Policy issue 2 - Unbundling different parts of a contract
  - **The industry agrees** with EIOPA's **assessment** which confirms that where the **insurer has a unilateral right** that only **relates to a part of the contract**, the **identification of this part should not be based on unbundling requirements**, but it should be based on the rights of DA Art 18(3).
- Paragraph 59 – EIOPA considers three options for **EPIFP** calculation.
  - In general, it should be noted that the calculation of EPIFP is already very burdensome especially for life insurers. Before discussing options, it would be very helpful if EIOPA could clarify the objective which is connected with this figure, ie how would it be helpful and support supervisors. The industry strongly doubts that without a clear view on the objective it is possible to design a result which makes sense.
- Paragraph 62: The benefits are not logically consistent. At least in non-life, business corporate management is not based on EPIFP but on completely different key figures. Against this background, EPIFP is determined solely for supervisory purposes and changing the calculation of EPIFP would not bring any additional benefits for insurers.
- Paragraph 70: EIOPA's proposal to clarify that obligations related to paid in premiums should be out of scope of DA Art 18(3), as such this article is only applicable to future premiums. **The industry partially agrees with the proposed clarification.** It would be deemed reasonable to apply contract boundary principles (ie Art. 18(3)) also to obligations (especially policyholders' options) emerging from paid-in premiums, where these give rise to the unilateral rights referred to in Article 18(3), because this would align more closely the projection of both premiums and options in the BEL calculation. In particular, consider options related to paid-in premiums such as maturity extension or annuity conversion at the maturity date which can be rejected or fully repriced (or determined only at option exercise These should not be projected where they satisfy Art. 18(3) requirements because their projection will introduce further uncertainty in the valuation; if they can be rejected or if a full repricing is possible, it could be debatable which assumptions should be used for related guarantees or conversion rates (if not contractually predefined). The application of contract boundaries principles (ie Art. 18(3)) to liabilities arising from paid-in premiums could introduce more objectivity in some instances (especially some policyholders' options where these give rise to the unilateral rights referred to in Art. 18(3)) in the valuation.
- Paragraph 71 – Policy issue 3.1 – drafting of third paragraph of Art 18(3)
  - **The industry takes note of EIOPA's proposal for a rewording to clarify that it is not an 'obligation' for insurers to perform an assessment at the level of individual contracts**. (DA Art 18(3), third paragraph).
  - At the same time the industry highlights that the amendment is in fact only formal. Indeed, if insurers determine prices at contract level in order to reflect individual risks (ie not at product level), then the contract boundary assessment should be done at contract level. The change is only formal because for the major part of the contracts, the premium rates are assessed according to age of head insured but not according to gender (prohibited). Therefore, the amendment does not clarify whether the prohibition to apply different prices for male/female would have as a consequence that risks are not considered as being assessed at contract level.

- Paragraph 72 – Policy issue 3.2 – exception of the third paragraph of Art 18(3)
  - The industry disagrees with EIOPA's proposal to clarify the exception that allows the extension of contract boundaries for contracts where an individual risk assessment has been performed at inception, specifying that the exception is to be applied only when the undertaking does not have the right legally/contractually to perform again the individual assessment (DA Art 18(3), third paragraph). As EIOPA itself notes in paragraph 3.58, the proposal would have a large impact in several jurisdictions, as it would substantially limit the possibility to extend the contract boundaries.
- Paragraph 73-74 – Policy issue 4.1 - **EPIFP**
  - **The industry disagrees with the amendments to DA Art 260(2) and 260(4)**.
  - **The industry is concerned by the implied assumption that an HRG may only contain profit- or loss-making policies, irrespective of the underlying risks. It believes this amendment should be dismissed.**
  - EIOPA did not provide convincing arguments why a net EPIFP should - for supervisory purposes - be split into the group of loss-making contracts and the group of profit-making contracts (per line of business) with the impact of reinsurance shown separately. Such information does not change the EPIFP's nature as a component of the reconciliation reserve and neither does it provide meaningful information on realizable cash values, as transactions are typically not mirroring regulatory contract groupings such as Solvency II defined homogeneous risk groups or Solvency II defined lines of business.
  - Implementing this EIOPA proposal would require the whole restructuring of HRG and model points in firms' systems for this sole calculation, let alone the fact that the concept of profitable/unprofitable HRG is hardly practicable when stochastic valuation methods are used (ie the same HRG can be profitable in X scenario simulations and turn unprofitable in X others or could be unprofitable up to a certain maturity and turns profitable thereafter).
- Whether HRGs are profitable or unprofitable is an output of the BEL calculation. As such, changing eg market conditions at each valuation date may change the allocation of policies, resulting in more volatile and unpredictable EPIFP figures. For example, in the Danish market there are specific bonus allocation rules, which allow for a collective bonus mechanism. As such, it is only possible to ascertain at a group level whether a certain group of policies are profit- or loss-making.
- Paragraph 75: The objective of the two new paragraphs added to DA Art 260 is unclear, and these should be rejected.
- Paragraph 76 – Policy issue 4.2 – Other future profits
  - **The industry deems the addition of a definition for 'the gross expected future profit/loss from servicing and management of funds' unnecessary**.
  - The objective of the addition is completely unclear, profit from servicing and management of funds is not comparable to profit stemming from future premiums and as such an analysis of future cash flows stemming from management fees from funds seems completely arbitrary. EIOPA is asked to clarify what special risk is connected to this figure.
  - Further, if "other expected profits" concern unit linked management fees, then there is a risk of double counting because some of these fees are embedded in the future premiums that will be paid.
  - In its assessment EIOPA ignores the cost of servicing and managing. This cost should also be included in the calculation and, if this was the case, it is possible that this issue may not be material anymore.
  - The management fees are contractually due by the policyholders and therefore not comparable to EPIFPS.

Q3.1: EIOPA is concerned that this could imply new burdensome calculation for some undertakings and therefore wants to ask the following question: Do you consider that homogenous risk groups may include profit-making and loss-making policies? If yes, why are these policies considered to be homogeneous even if a key aspect like profitability is so different? Concrete examples to illustrate the answers will be welcome.

Both the split into loss making and profit making as well as the separation of impact of reinsurance would only be an additional burden without any gain in more insight. Policies within one homogenous risk group can differ by guarantee level, but as well by different contractual and policyholder characteristics resulting in different

levels of profitability. In more detail, EPIFP is very much dependent not only on the risk profile of policies but also the current state (capital markets, assets held, assumptions for profit sharing…). To illustrate this, consider policies with guaranteed interest rates. For the valuation of the technical provisions at December 31st, 2018: EPIFP may have been positive for all policies in one homogeneous risk group. As of September 30th, 2019: the same homogeneous risk group may contain policies with positive or negative EPIFP depending on the remaining durations of the policies. Especially for policies with collective profit-sharing mechanisms requiring stochastic Monte Carlo simulations for the BEL it is virtually impossible to precisely derive homogeneous risk groups that are homogeneous with respect to the sign of EPIFP.

Generally, a sufficiently granular approach on the risk characteristics provides a clear split between HRG including profit-making and HRG including loss-making policies (including in-force engagements and EPIFP).

Further, HRGs may include both profit- and loss-making policies. HRGs are only based on risk characteristics of the contracts. For example, in Denmark, because of the unique Danish bonus mechanisms in traditional products, it would be very burdensome to ascertain if policies are profit- or loss-making at valuation. It would probably also require a policy-by-policy projection, to be able to create model points within profit- and loss-making policies, and it would definitely not lead to a better reflection the risk of the contracts. Other examples of HRGs that include profit-making and loss-making policies are life insurance contracts with surrender fees. These could be profitable up to a particular duration (for example 6 years), and could be loss-making if they last longer than that. Likewise, in Italy several contracts exist for which the benefit is linked to the return of the same fund, that is attributed to the bulk of contracts on annual basis. Those contracts can be considered homogeneous groups even if they have minor differences in contractual features (e.g. different charges).

For Non-Life business the identification of profit/loss making contracts is often too granular to assess; at contract by contract level such information on profitability might not even be available. It is not possible to distinguish between profitable policies and loss-making policies at a contract level. For a given policy it is not possible to tell in advance whether it will make a profit (ie there will be no claim) or a loss (ie there will be claims). This means that HRGs cannot be more granular than product portfolios.
In the case of policies issued to larger groups of risks (e.g. motor fleet) the HRGs are already created taking into account the available information.

Further, it is unclear how a split should be made in practice. Assuming a division with respect to the expected amount of loss, it may be necessary to review it annually; for individual contract generations typically a change in their profitability is observed over time. As a result, the division into HRGs would not be stable. Against this background, it is unclear why profitability should have any significant impact on the risk of the contract.

Additionally, when calculating the impact of reinsurance on EPIFP, the HRGs have to be compatible with the reinsurance contracts. For example, for a stop-loss-reinsurance contract for a specific LoB, the reinsurance impact on EPIFP can only be determined if all contracts of this LoB are considered in the gross EPIFP calculation. If the LoB was be split into parts for the gross EPIFP calculation, it would not be possible to determine the impact of reinsurance. As such, when determining the HRG for the (gross) EPIFP calculation, the reinsurance contract's structure has to be considered. Further split into loss making and profit making as well as the separation of impact of reinsurance would be an additional burden.

Besides, the scope for EPIFP and BE must be identical for comparison/analysis purposes, both for the undertaking and the supervisor. Establishing a split between EPIFP and BE in building the HRG would require a lot of implementation work and cost with almost no benefit for supervision.

Future management actions

- Paragraph 83: Best estimate valuation in life insurance with a stochastic model includes various management actions. These are necessary components of these models. The industry agrees that their implementation in these models must not be linked to business plans.
- Paragraph 85 – definition of future management actions
    - **The industry notes that a common definition may potentially be helpful**, the wording "under specific circumstances" recognizes that, in stochastic valuation, specific FMA can be implemented in specific scenarios.
    - Besides, FMA should not be challenged against past because some FMAs can be taken in very specific circumstances which have not yet occurred. FMAs should reflect the potential actions that the AMSB may take in the future. The proposed definition with the wording "may expect to carry" reflects this.

Expenses

- Paragraph 102 – Policy issue 1 – new business
    - The industry welcomes the clarification amending DA Art 34(4), which reflects economic reality. As it is our current understanding that the going-concern principle in the Delegated Regulation means "business as usual".

Q3.2: Do you consider that the proposed definition may introduce barriers to entry for new undertakings? If yes, please elaborate the answer.

No

- Paragraph 103 – policy issue 2 – drafting amendment
    - The industry welcomes EIOPA's amendment to DA Art 31(1) 'to have to take into account assumptions on expected future expenses', both in increase and decrease.

Valuation of options and guarantees

- Paragraph 120: While EIOPA is not proposing any amendment to the DA, it proposes to provide further guidance on the calibration of dynamic models and to clarify that the lack of data for extreme scenarios is not a reason itself not to model dynamic PH behaviour.
    - Indeed, in some jurisdictions modelling dynamic lapses is the default in life insurance. And the models are widely accepted unless it is hard to calibrate them on historic data. Their calibration relies mostly on expert judgement.
    - **While the industry agrees with EIOPA's choice for option 1 (no change), it highlights further guidance from EIOPA is not necessary since EIOPA itself does not seem to feature better evidence on policyholder behaviour than the undertakings.**

Q3.6: Do you consider a unique definition of homogenous risk groups for calculation purposes? (e.g. cash flows projections, technical hypothesis calibration etc.)

The industry defines homogeneous risk groups based on risk characteristics of the contract itself.

No, HRGs used for cash flows projection do not necessarily correspond to HRGs used for best estimate assumption setting. When defining best estimate assumptions, in order to give statistical relevance to the observed frequencies, a different aggregation may be necessary rather than the one used for cash flow projections.

Q3.7: Considering Life business: Do you consider homogeneous risk groups to be the model points used to reduce run-time of stochastic modelling? If the answer is "No", please elaborate it. No. We consider model points more granular than homogeneous risk groups. As some solvency reporting is performed at the homogeneous risk group level, it would be unrealistic to do this at model point level.

Q3.8: Do you consider for reporting purposes the same homogeneous risk groups used for best estimate valuation? And for EPIFP calculation? If the answer is “No”, please elaborate it.

Mostly yes, however, in some cases the HRGs used for reporting purposes (e.g. QRT S.14.01) are typically an aggregation of a more granular level of HRGs used for the calculation. This is to have an appropriate balance in terms of informativeness of the reporting and its level of granularity.

Q3.9: Do you consider that a 0% minimum guaranteed interest rate or a partial/full capital guarantee have a discernible effect on the economics of the contract (Yes - No - Depends on the contract, economic situation and/or other products available to policyholders)? In any case, please elaborate the answer. It is considered that the 0% minimum guarantee or a partial/full capital guarantee have a remarkable effect on the economics of the contract, especially in a prolonged low (or negative) interest rate scenario.

Section 3.2 Risk margin

The industry is disappointed by EIOPA's decision to maintain the status quo. EIOPA does not address the issues relating to the risk margin (RM) nor fix its flaws. In the CfA EIOPA is explicitly asked to 'assess the ongoing appropriateness of the assumptions used to derive the CoC, including the absence of leverage and the derivation of the ERP.

The RM is excessively high, especially for long-term business and its excessive sensitivity to interest rates is another source of artificial volatility. These issues are particularly problematic for long-term products. The industry highlights that there are a range of technical arguments which, taken together, support a significant reduction in the RM. EIOPA should put more effort into this area as mandated in the CfA.

The following issues regarding the RM should be addressed, and throughout the present response the industry proposes various ways to solve these.

- The CoC is exaggerated and should be reduced to an appropriate level. A 3% CoC is deemed appropriate.
- The RM is overly sensitive to interest rates.
- The calculation of the RM does not allow for diversification between life and non-life business within the same entity, or between different entities within a group.
- The RM does not reflect appropriately risk interdependence over time.

- Paragraph 144: EIOPA notes that *'the CoC was reviewed in detail as part of the Second set of Advice to the EC, and is fixed at 6% for all undertakings. It was not deemed necessary to repeat this analysis.'.* The industry highlights that it provided substantial evidence justifying a lower CoC, which was mostly ignored by EIOPA, and EIOPA never published a resolution of comments for the second set of advice of the 2018 review. In addition, the industry shared a paper, highlighting a number of flaws in the EIOPA analysis, to which EIOPA never responded.
- Paragraph 157: The data available on the transactions is very limited, and therefore it is not suitable to perform any analysis. In addition, data since 2016 corresponds to different phases of the economic cycle. e.g. low interest rate period. Further, EIOPA considers data by line of business. This could lead to erroneous conclusions, as the compiled data is reduced. A bigger sample population would be required to evaluate transaction costs in a meaningful way.
- Paragraph 162 – **Design of the RM and transfer value concept**:
  - EIOPA starts its analysis with 44 datapoints, but after excluding datapoints for reasons of data quality, forced sales and open books, only 7 datapoints remain. EIOPA itself notes that the dataset may be too small to draw any conclusions.
  - **The industry agrees with EIOPA that the analysis has significant limitations due to lack of information.** Since the analysed data is not homogeneous, it is difficult to quantify the real cost of the transaction, ie the cost of capital based on the difference between the assets transferred and the technical provisions.
- Paragraph 182 : **The industry agrees with EIOPA's proposal to maintain the current approach not including the MA in the RM calculation**.
- Paragraph 195 : **The industry agrees with EIOPA's proposal to maintain the current approach not including the VA in the RM calculation**.
- Paragraph 203.3.c: EIOPA notes that the sensitivity of interest rates increases with an increase in the EUR LLP from 20 years. Against this background, the industry highlights that if the best estimate were to increase following a decrease in the extrapolated part of the interest rate curve, the RM should be decreased accordingly taking into account the decreased discount rates applied to future capital requirements. This would ensure that technical provisions are not overstated further and avoid introducing even further prudence in an already inflated RM.

- Paragraph 204: The industry highlights that the low interest rate environment has a significant impact in the calculation of an evidence-based CoC rate. Ignoring the current situation leads to an overestimation of the RM.
- Paragraph 203/204: EIOPA sets out the conclusions of its analysis, thereby highlighting that '*the sensitivity of the RM to interest rate changes is as expected, with the highest sensitivity for long term products with high underwriting risk*'. In paragraph 204 EIOPA dismisses the idea to make the CoC rate dependent on the level of risk-free interest rates, arguing that, based on analysis from the second set of advice, the empirical and academic evidence to support a link between the equity risk premium and risk-free interest rates is mixed. **The industry is disappointed with EIOPA's lack of ambition and believes that there is sufficient evidence in EIOPA's analysis to conclude that the RM is overly sensitive to changes in risk-free rates.**
- Paragraph 208: EIOPA notes '*it has no evidence or indications that the conclusions drawn in the 2018 review are not valid anymore. Therefore, no additional analysis was carried out.*'
  - The industry shared an extensive paper with proposals. The industry identified a number of flaws in EIOPA's approach to determine the CoC, including the items raised by the Commission in the CfA.
  - An overview of issues and their flaws are identified in the table below.

Flaws	Equity Risk Premium	β	Adjustment	Difference vs EIOPA *(per parameter)*	Corrected Cost of Capital *(cumulative)*	Explanation
Technical error – **inconsistent assumptions behind parameters**	*[7.02%-8.09%]*	*0.90*	*0.80*	(1.68%-1.94%)	**5.05%-5.82%**	Using an industry β without a deleverage adjustment is <u>incompatible</u> with EIOPA's 100% equity funding assumption for reference undertaking
Incompatible with SII Delegated Regulations - **no correction to β for minimal market risk**	*[7.02%-8.09%]*	*0.81*	*0.80*	(2.19%-2.52%)	**4.55%-5.24%**	Using an industry β without an adjustment reflecting that market risk has been hedged is <u>incompatible</u> with the requirement to minimise market risk within the Reference Undertaking as set out in Solvency II Delegated Regulations article 38(h)
Equity Risk Premium (ERP) that is inconsistent with SII regulation and ignores assessment from a range of expert studies	*[4%-6%]*	*0.81*	*0.80*	(4.15%-3.88%)	**2.59%-3.89%**	ERP selected by EIOPA is backward looking, which is inconsistent with art. 77.5 and is materially higher than the recommendation by expert studies due to a range of issues

  - **The analysis above results in a beta in the range of [0.81 – 0.9] and an equity risk premium in the range of [4% - 6%] leading to a Cost of Capital between 2.6% and 3.9%.**
  - In addition, recent industry analysis has identified a further inconsistency in EIOPA's methodology, namely the fact that EIOPA calculated the average beta parameter based on market-capitalisation

weights. This weighting distorts the results because the betas of the individual undertakings are strongly correlated with market capitalisation. Introducing a more appropriate approach of equal weighting for each undertaking, would reduce the beta from 1.2 to 0.75 and further support a re-calibration of the CoC to 3%.

- Paragraph 210 – The industry is disappointed with EIOPA's decision not to propose any change to the RM calculation.
  - The 2020 Solvency II review is the right time to review the RM. The current RM methodology leads to additional capital requirements and creates artificial balance sheet volatility due to, for example, significant prudence embedded in its calibration.
  - Regarding the **transfer value**, the industry agrees with EIOPA that the analysis has significant limitations due to lack of information and data interpretation, therefore, the analysis should be further enhanced.
  - Regarding the **assumptions underlying the reference undertaking**, the industry agrees with EIOPA's proposal to maintain the current approach not including the MA/VA in the RM calculation.
  - Regarding the **Cost of Capital**, it is currently set at 6%, which is too high. As a fixed parameter, irrespective of the level of interest rates, it creates artificial balance sheet volatility. The CoC rate should be set to 3%, as indicated in previous industry analysis.
    - The industry highlights that there is sufficient evidence in EIOPA's analysis to conclude that the RM is overly sensitive to changes in risk-free rates.
    - EIOPA dismissed the industry proposal to make the CoC rate dependent on the level of risk-free interest rates, arguing that based on analysis from the second set of advice the empirical and academic evidence to support a link between the equity risk premium and risk-free interest rates is mixed.
  - Regarding the **assumptions used to derive the CoC rate**, EIOPA noted *'it has no evidence or indications that the conclusions drawn in the 2018 review are not valid anymore. Therefore, no additional analysis was carried out.'* Yet, back in 2018 the industry shared a paper in which it identified a number of flaws in EIOPA's approach to determine the CoC, including the items raised by the Commission in its CfA.

Q3.3: Is your experience, if relevant, consistent with our conclusions that the risk margin can be more sensitive to interest rate changes for longer term business?
Yes, due to the discounting of the risk margin cash flows and the impact of interest rates on the level of the SCR.

Q3.4: What is your view on the assumptions underlying the reference undertaking where the original undertaking applies the MA or VA? Considering the approaches for RM calculation outlined in section 3.2.7.2, are any of the noted pros and/or cons inconsistent with your own views or experience?
The recognition of the MA/VA in the relevant risk-free interest rate term structure used for the discounting of the future SCRs could increase consistency between the undertaking and the reference undertaking. However, the application of the MA/VA in the current reference undertaking leads to the existence of a spread risk in the calculation of the future SCRs. The industry agrees with EIOPA that this measure could lead to an increase in the sensitivity of the projected SCRs to changes in interest rates. Therefore, taking into account the pros and cons detailed by EIOPA, the industry agrees the VA/MA should not be included in the calculation of the RM.

Q3.5: Please note any possible approaches to the calculation of the RM you believe should be considered that have not been included under section 3.2. Please justify any such approaches.
The industry refers to **analysis produced back in 2018** which highlights flaws/inconsistencies in the current Solvency II CoC rate.

- **Issue – The level of the CoC is excessive**
  The industry acknowledges the efforts of EIOPA in reviewing the calibration of the CoC rate during the 2018 Solvency II Standard Formula Review. However, the industry considers that the information and

sources used to derive the CoC of 6% which were presented in the context of the 2018 review tend to include an upward bias. Furthermore, EIOPA has made very conservative choices for parameters and estimates to derive the CoC rate from these sources.

The general approach adopted by EIOPA corresponds to estimating the cost of capital under a Capital Asset Pricing Model (CAPM) approach, which estimates the cost of capital as a function of the expected return on the market portfolio and 'beta' value:

CoC rate = β*[Equity risk premium]

EIOPA has followed this approach and, having derived an estimate of a beta value of 1 and an equity risk premium of 6%, it has arrived at the CoC rate of 6%.

While EIOPA has made some necessary adjustments to estimate the beta value, not all necessary adjustments have been made, and those that have been made were set at an excessively prudent level. In fact, the industry highlights that several further adjustments are necessary to ensure that the CoC is appropriately justified. Industry analysis clearly illustrates that a value of 3% for the Solvency II CoC rate is appropriate, yet remains highly prudent. The industry outlines a number of areas below by which the current approach to setting the cost-of-capital rate could be refined.

Consideration of debt/use of unlevered beta

The CoC should take into account the share of debt held by insurers. The current derivation is flawed as it does not do this, and so derives an upwardly-biased cost of *equity* rather than a CoC (ie weighted average cost of capital, or "WACC").

Given this, the CoC calculation should take into account the financing structure of insurance capital. The WACC can either be calculated explicitly, or through the use of an unlevered beta, which corresponds to the estimated beta of companies if they were to hold no debt, and therefore corresponds to an estimate of the WACC.

Estimating the WACC directly could potentially be onerous. Instead, the use of an unlevered beta would be a more practical way to estimate the WACC as estimates of this are already available from external sources. For example, a comprehensive NYU Stern study (link) finds an unlevered beta for insurance companies of 0.65.

Use of a forward-looking Equity Risk Premium (ERP)

EIOPA in its second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation (EIOPA-BoS-18/075) suggests using only historic return models to ensure methodological consistency, stronger stability and lower dependence on assumptions.

However, there is considerable scientific evidence that the backward-looking ERP is an upward biased estimate of the true theoretical ERP, which is forward-looking by virtue of the CAPM definition. For example, Ibbotson and Chen (2003)[7] show that after accounting for unexpected capital gains, the ERP for the USA is reduced significantly, by 2% (ie 200bps). In a similar vein Fama and French (2002)[8] show that the backward-looking ERP over 1951 and 2002 was also 2% higher than the forward-looking one. The ERP based on historical return models requires certainly fewer assumptions to be calculated. However, if using an historical return ERP, it is essential to address its upward bias, by making a -2 % correction.

Use of arithmetic vs geometric mean

The ERP results presented in the scientific articles and analytical reports use an arithmetic and a geometric mean. The use of an arithmetic or a geometric mean can produce materially different results. Therefore, the use of a geometric mean in deriving the CoC rate should also be considered.

[7] Roger G. Ibbotson and Peng Chen, "Long-Run Stock Returns: Participating in the Real Economy," Financial Analysts Journal, vol. 59, no. 1 (January/February 2003)

[8] Fama and French 2002. The Equity Premium. Journal Of Finance, 57(2), 637-659

Use of a market risk premium

The CAPM approach used to estimate the cost of capital should take into account a diversified market portfolio ie a globally diversified portfolio including asset classes other than equites – which would lower the market risk premium. The impact of this on the beta values should also be considered.

Adjustment for pure insurance risks

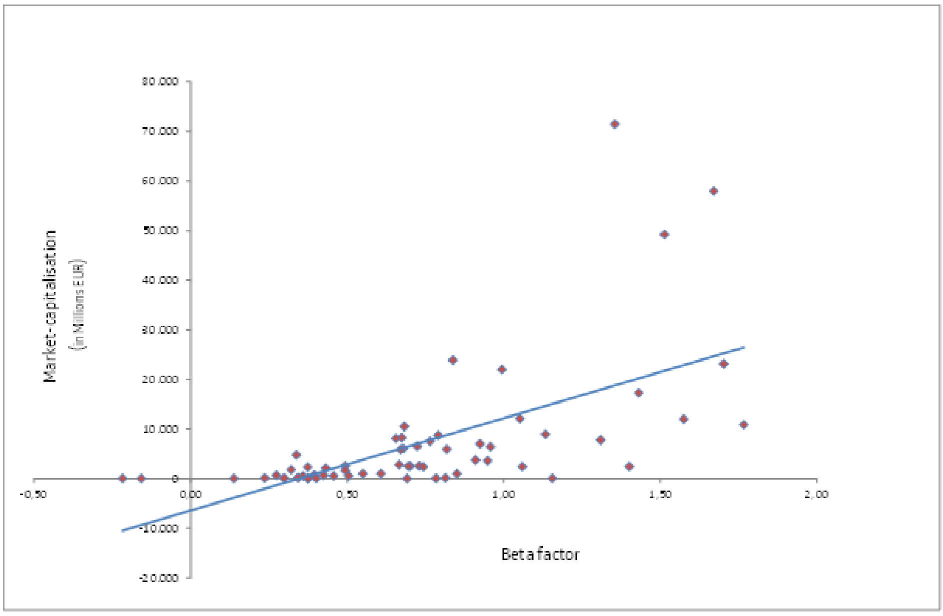
A key source of return for going concern undertakings relates to expected profit from new business. However, the reference undertaking is closed to new business and therefore any estimate of the CoC rate should be adjusted downwards in order to remove the impact on this of the compensation for franchise risk that investors require to invest in ongoing insurance entities and will not require this compensation for the transferred run-off portfolio.

Furthermore, the reference undertaking is assumed to hold no risky assets whereas ongoing insurance entities, on which the cost of capital is based, do hold a significant amount of market-risky assets (e.g. equities, bonds). Therefore, the CoC rate should be adjusted downwards to account for this because by its definition, the "total return" CAPM cost of capital reflects already all the risks and costs assumed by investors.

The general CAPM framework is not designed to reflect only the cost of running off pure insurance risks as it is the case with the RM; the CoC rate is used in relation to future capital requirements mainly for underwriting risks. Thus, when using the CAPM, the beta factor should reflect the low dependence between insurance risk and general equity risk. Ideally the covariance of pure insurance risks with market returns should be used for the calculation. To apply a beta factor which refers to equity prices of listed insurers seems to be already a conservative estimate because insurers' equity prices are not only driven by insurance risk but also by their assets and franchise risk.). Industry analysis indicates a downward adjustment of 30% is necessary to account for these two effects. The 30% adjustment is likely to be conservative when considered in the context of the risk profiles of life insurers in particular who carry large amounts of asset risk. This level of adjustment is consistent with the downward adjustment assumed by CEIOPS in its 2009 final advice on the RM.

Consideration of the broad market

Even if one follows EIOPA's approach to calculate beta based on the co-movement between the share prices of European insurers and the general equity market (see EIOPA's second set of advice on the 2018 review), the calculated beta is overestimated. The reason for this was a substantial overweighting (using their market capitalisation) of a few large companies which belong to major equity indices. The increasing investment in passive investments - which simply replicate an index - and the close following of many actively managed funds, leads to an increased co-movement of these large companies with the reference index. However, this artificial effect provides no further information on the underlying risk of these companies and their businesses. Accordingly, current data proves that smaller companies exhibit a significantly lower co-movement with the index (see graph below). Therefore, when reflecting the correct weight for these few large companies, the co-movement between listed insurers and the general equity market is much lower. If the insurance companies in the sample are equally weighted, the – more representative – result for beta is only 0.75 instead of 1.2 (weekly data 2006–2016; and application of daily data would lead to an even lower beta). The lower beta justifies a substantially lower CoC rate of around 4%. It should be noted that this value is probably still conservative as listed insurers are not a representative sample of the European insurance market.



Graph: Statistical relationship between Beta factor and market-capitalisation, Source: GDV

An additional plausibility check for the order of magnitude and illustration of the effect of deleverage is given by US data.
For other parts of its analysis, EIOPA based itself repeatedly on results from Aswath Damodoran. The industry highlights that the values of the beta by industry sector available on Damodaran's website (link)s of January 2019 are as follows:

- Insurance (General): raw beta = 0.87; unlevered beta = 0.64
- Insurance (Life): raw beta = 1.11; unlevered beta = 0.62
- Insurance (Prop/Cas.): raw beta = 0.74; unlevered beta = 0.62

<u>Summary</u>
The current 6% level of the Solvency II CoC rate is excessive because:

- It was calibrated based on backward-looking ERP, rather than forward looking market risk premium, which introduces a strong upward bias;
- It was calibrated based on a 100% equity funding assumption but with the use of a levered beta (which is completely inconsistent), and without adjusting the beta for the run off of pure insurance and asset risk.

This leads to a level of the RM which is too volatile and does not seem reasonable within the Solvency II framework.

If EIOPA persists with an assumption of pure equity funding, then the Solvency II CoC rate from the standard CAPM methodology should be derived in the following way:

CoC rate = (1-x)β*[Market risk premium]

Where:

- **Market risk premium** represents the expected return above the risk-free rate that investors would require in order to hold a global diversified portfolio containing all market assets, including equities and bonds, on a forward-looking basis.
- **β** is the unlevered beta of the insurance sector. Using an unlevered beta is consistent with CEIOPS' assumption that firms are 100% funded by equity, which will tend to add a layer of prudence in the calibration of the CoC rate. Not using an unlevered beta in this context would result in an inappropriately high cost-of-capital.

- **x** is the adjustment required to derive a beta for pure insurance risks – ie excluding the impact of franchise risk and assets held by insurers (which are more correlated to the rest of the market).

Industry analysis supports the following ranges of values for the parameters outlined above:

x = 30%: this is derived from conservative estimates of the impact of franchise risk, and the impact due to assets held by insurers. This level of adjustment is consistent with the downward adjustment assumed by CEIOPS in its 2009 final advice on the risk margin.

β = 0.65 - 0.8: This represents a prudent range for the unlevered beta for insurers based on a realistic estimate of 0.65 from a comprehensive NYU Stern study (link). (Alternatively, if not considering the unlevered beta, the Weighted Average Cost of Capital approach would also lead to lower the Cost of capital derived from the CAPM).

Market risk premium = 4-5%: A backward-looking assessment of the risk premium for a diversified world equity portfolio would support a value of around 5%-7%. However, this does not take into account that a globally diversified portfolio contains assets other than equities, in particular bonds which have lower risk premiums and does not account for the fact that backward-looking risk premiums contain a strong survivorship bias. Studies support at least a 2% downward adjustment to take account of these effects. This is consistent with average estimates of forward-looking Equity Risk premiums by Thomson Reuters (4.5% worldwide)[9].

Taken together, these assumptions produce a Solvency II CoC rate of around 2%-3%. Therefore, this industry analysis clearly illustrates that a value of 3% for the Solvency II CoC rate is appropriate and still remains prudent.

- **Issue - Excessive volatility of the RM with respect to interest rates.**
  Decreasing interest rates have resulted in excessive values of the RM, amplifying the prudence embedded in its calculation and clearly demonstrating that the current calculation is excessively volatile with respect to interest rates. The interest rate impact on the RM is twofold:
  - Direct discounting effect - Lower interest rates lead to the use of lower (risk free) discounting rates when calculating the present value of the stream of SCR capital amounts. This results in a significant increase in the RM.
  - Indirect discounting effect - the SCRs themselves may increase when rates are falling depending on the pattern of the liabilities.

  Both effects are significant in terms of impacting the size of the RM. An excessively conservative calibration and calculation of the RM is therefore more pronounced with the current low rates because it exacerbates the impact of volatility in absolute terms. This has led to an excessive level and volatility of the risk margin that are the result of a hedgeable risk (interest rates) which the risk margin is not intending to cover. The excessive level of the risk margin may also incentivize firms to de-risk as interest rates fall, resulting in procyclical activity during market downturns.
  For example, it is estimated that a 1% decrease in interest rates can result in an increase in the RM of more than 20% for longer duration portfolios. Given the excessive size of the RM, this can represent an extreme change and will impact negatively on insurance firms' solvency ratios. This is not reflective of the behaviour of transfer pricing in the market, which takes into account a longer-term view of the risks involved and is much less sensitive to current discount rates.
  The lack of the CoC sensitivity to interest rates is a major drawback because it ignores the fact that in a low interest rate environment, market risk premiums might be expected to reduce as demand for higher yielding assets increases. Such a link between the CoC rate and interest rates is also considered

[9] Downloaded directly from Datastream, and based on ASR (Absolute Strategy Research), which relies on the median of 8 different methods to calculate the Risk premium (https://www.absolute-strategy.com/x/erp.html)

and discussed in more detail under the context of frictional market effects in the CRO Forum paper (2008 - link). This report found that the relationship between the CoC rate and the risk-free rate was approximately linear, with the CoC rate for a BBB-rated insurer increasing by 0.3%-0.4% for every 1.0% increase in the risk-free rate.

Such a relationship is economically justified based on double taxation costs, which correspond to the compensation for corporate tax incurred on the base cost of capital. Investors ask for risk-free return plus a spread. When investing into an insurance company, double taxation arises because the company's' return is subject to corporate taxes. Given this, the return should allow for the corporate tax rate for the purpose of determining an appropriate CoC rate.

For example, consideration could be given to making CoC rate a function of the level of interest rates. That said, the volatility is amplified by the conservativeness in other parts of the RM calculation. In other words, an excessively prudently set cost of capital increases the absolute amount of the RM and therefore the absolute amount of volatility. Removing excessive prudence in the RM calculation will help to curtail its volatility to more appropriate and realistic levels.

- **Issue – No allowance for risk dependence over time**

  The current approach for calculating the RM treats all future capital funding requirements as independent payments (ie based on future unconditional SCRs) and does not take into account any dependency over time. However, any economic approach to valuing risky payments would have to take into account the dependence of risks over time to avoid inappropriate conclusions – such as policyholders lapsing more than once, or implausibly low mortality rates which imply that more capital is at risk than the worst-case scenario of policyholders living forever. In other words, **the current implementation of the RM may be flawed where this is not reflected in the projection of the cashflows because it may effectively assume that projected SCR equates to capital at risk.**

  In practice, **the projected SCRs do not always equate to capital at risk**. **This is because some risks are not independent over time.** Some non-hedgeable risks (such as mortality/longevity risk and lapse risk) are effectively non-repeatable, so if they crystallise in one time period they cannot reoccur. For example, lapse exposure reduces following a lapse stress, ie a 40% lapse stress in one year followed by a 40% lapse stress in the next year equates to a 64% total lapse (and not 80% as implied by the current approach). This will have a downward impact on the calculation of forward SCR capital requirements.

  The non-repeatability means it is not appropriate to value the projected SCRs in the RM calculation as independent payments, which is the presumption implicitly made when applying the formula currently specified in Article 37(1) of the Delegated Regulation.

  <u>Example: lapse risk</u>

  To see why projected SCR does not always equate to capital at risk, consider the case of lapse risk. In this case, the current design of the risk margin clearly overstates the capital at risk by a large margin because it does not take into account that exposure reduces post a lapse stress, and so assumes that risky capital will have to be raised in excess of the maximum possible loss. In many cases, this means that the current design of the risk margin ends up charging for capital that is more than sufficient to cover a total lapse rate of 100%.

  As an illustrative example, consider a five-year product (with constant exposure) prone to lapse risk. Assuming a 1-in-200 lapse rate of 40%, the current approach to calculating the Risk Margin implies capital at risk equivalent to a lifetime lapse stress of 200% - or every policyholder lapsing twice.

  In reality, the capital at risk is much lower and corresponds to a mass lapse stress of 40%, followed by a 40% mass lapse stress and by a further 40% lapse stress and so on, which is equivalent to a total lifetime lapse rate of 92% (= 1 – $(1\text{-}0.4)^5$). That is, the marginal impact of successive lapse shocks reduces in line with exposure and the capital at risk is much lower.

Here, the shortcomings of the current approach can be seen clearly – the total amount of capital being charged for is enough to cover a total lapse rate of 200%, or every policyholder lapsing twice. This is clearly not possible and so obviously in this case projected SCR does not equate to capital at risk. In other words, exposure reduces following a mass lapse stress and so the capital at risk is significantly lower. Consequently, any investor providing the capital required to support regulatory requirements for the reference undertaking would not be expected to charge a cost of capital rate for the proportion of capital that is not at risk.
Put in a different way, *an investor would charge a lower cost of capital to fund regulatory capital requirements for a particular risk that exhibits risk dependence over time than an equivalent risk with no dependence over time*.
A similar pattern also emerges with other risks under consideration. For example, mortality risk (in particular with respect to funeral business), morbidity risk, and longevity risk.

Proposal - Alternative 'Path Dependency' approach

Undertakings should be allowed to use a scalar λ to derive the projected SCR in the RM formula
The industry proposes that undertakings are allowed to model risk dependence over time in their SCR projections in the RM calculation. Therefore, undertakings should be allowed to use a scalar λ as one possible way to derive the projected SCR in the RM formula provided in Article 37(1) of the Delegated Regulation ie:

$$RM = CoC \sum_{t \geq 0} \frac{SCR(t)}{\left(1 + r(t+1)\right)^{t+1}}$$

where $SCR(t) = \lambda^t \, SCR'(t)$ and $SCR'(t)$ denotes the unconditional SCR at time t, where $\lambda \leq 1$. In this context, λ represents an estimate of the degree to which the ultimate risk reduces relative to a series of independent risks, and is linked to the reduction in size of future 1-in-200 risks following a 1-in-200 loss in previous periods.

As mentioned above, this can also be viewed as investors charging a lower forward cost of capital rate for projected SCRs to reflect a lower overall risk. In this context, additional justifications also can be made to support a declining forward cost of capital rate. For example, it could be argued that the immediate cost of capital rate reflects frictional costs, such as asymmetric information between an insurer and the market around the portfolio-specific risks of the business being transferred. However, when we consider forward cost-of-capital rates, such informational asymmetries will reduce over time as external factors become more prevalent than portfolio-specific factors, and this would lead to investors requiring a lower forward cost-of-capital rate – also leading naturally to the use of the lambda parameter.

- **Issue – lack of diversification**

According to recital 55 of the Solvency II Directive, the value of technical provisions should correspond to the amount an (re)insurer would have to pay if it transferred its contractual rights and obligations immediately to another (re)insurer.
In this context, the industry supports Art 77(5) of the Directive in its current form, stating that: "*[…] the risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement (SCR) necessary to support the insurance and reinsurance obligations over the lifetime thereof.*" This paragraph is geared towards the RM of an insurance undertaking, and so it appears counterintuitive that Solvency II regulation via the Delegated Acts does not apply this Directive principle consistently with respect to diversification. Indeed, the current RM approach does not give sufficient allowance for diversification between risks within an insurance company and within insurance groups.

Proposal: More diversification should be recognised within the reference undertaking

- Group diversification: Currently, the consolidated RM has to be calculated as the simple sum of the RM of the participating (re)insurance undertaking and the proportional shares of the RM of related (re)insurance undertakings. This effectively means that it is calculated gross of intra-group transactions. This implies that no diversification benefit can be assumed between different entities of a group, while it would be reasonable to assume that the level of diversification a group manages to achieve could also be reproduced by a reference undertaking. In contrast to this, the Swiss Solvency Test for example consistently allows for Group wide diversification at Group level for both, risk capital and RM (market value margin, respectively).
- Diversification between life and non-life: When calculating the RM, for a composite insurer, pursuing both life and non-life business, an assumption is currently made that the life and non-life insurance obligations are taken over by two separate reference undertakings. This implies that no diversification benefit can be assumed between life and non-life insurance portfolios. This separation of life and non-life obligations is arbitrary and should therefore be removed.

In both cases, regulation in a straightforward way allows for diversification between lines of business and, in the case of groups, group-wide diversification when calculating the SCR, but then artificially restricts its allowance for the determination of the RM (in DA Art 38(1)(b) and Art 340).

The main purpose of the RM is to ensure that the value of the technical provisions is equivalent to the amount that (re)insurers would be expected to require in order to take over and meet the (re)insurance obligations. Consistent with previous work of 2008 (CRO Forum - link) on properly taking into account diversification effects, such a restriction is not reflected by actual experience, leading to an unnecessarily conservative assumption in the RM calculation for groups.

For example, as part of general market practice, we commonly see there are for instance groups, including all subsidiaries, that have been subject to a takeover: Resolution (purchased by Pearl Group), Friends Life Group (purchased by Aviva), Delta Lloyd (merged with NN) and AIA (aborted purchase by Prudential plc). Therefore, the assumption that the portfolio of each entity in the group is transferred to different (re)insurers is not supported by actual experience and leads to an unnecessarily conservative assumption in the RM calculation for groups.

With diversification being the fundamental principle of insurance itself, its adequate allowance in the Solvency II balance sheet appears to be a key issue, hence the industry regards appropriate adjustments necessary in the DA Art 38(1)(b) and Art 340 to achieve consistency between the SCR and the RM calculations and to align the level II with the level I Directive. Specifically, this arbitrary separation of obligations should therefore be removed, and the RM methodology should be amended to allow for diversification between lines of business within a composite firm and legal entities within a group by, for example:

- Deleting DA Art 38.1(b) and amending DA Art 340 that the consolidated risk margin of technical provisions shall be calculated on the basis of the consolidated data – similarly to Dir Art 230(1)(b) and the DA Art 336. And also similar to the Swiss Solvency Test.

- **Longevity considerations**

There is now compelling evidence of a strong market in longevity hedging, primarily via longevity swaps but also via reinsurance structures, as insurers are now prepared to exchange significant potential returns for certainty of outcome. This has arisen primarily due to the flawed calibration of the RM under Solvency II.

DA Article 38 (1) provides a list of assumptions regarding the reference undertaking, in order to calculate the RM. Specifically, DA Art 38(1)(l) states that "*the reference undertaking will, subject to points* ***(e)*** *and* ***(f)****, adopt future management actions that are consistent with the assumed future management actions, as referred to in*

*Article **23**, of the original undertaking."* As there is now a deep and liquid market for longevity hedging, companies should be able to make use of this and it should be possible to include a management action which puts longevity reinsurance in place.

The hedgeability of longevity risk opens the possibility for the following proposals:

Proposal: Reinterpretation of technical provisions

- Given the recent longevity risk transfer activity since the finalisation of the Solvency II text, it is now unreasonable to assume no longevity risk can be transferred throughout the period of run-off. Therefore, the industry proposes that for the determination of the RM, undertakings should be able to use longevity reinsurance to price the transfer value of the risk.
- Under current legislation, the projected SCRs used in determining the RM should be calculated for a reference undertaking which has purchased assets to optimise its capital position. The industry proposes that this asset-side restructuring to minimise the SCR should be extended to include the ability of firms to hedge longevity risk. Firms should assess how much longevity exposure they believe could be traded out and at what cost, both in terms of quantum at time zero, and run-off over time. The net exposure could then be used in the projected SCR calculations for RM purposes.

Proposal: Adoption of a future management action putting longevity reinsurance in place

- In short, the Management Action Solution involves an insurer approving a management action that provides that it would seek reinsurance to cover certain liabilities in specifically defined circumstances, namely when it de-risks its assets. If certain current assumptions in the RM framework remain unchanged, these defined circumstances would be deemed to occur upon any transfer to a transferee insurer, and therefore the transferee insurer can be treated (for the purposes of the RM calculation) as having put in place longevity reinsurance in line with the management action. This management action would be reflected in determining the transferee insurer's SCR for the purposes of calculating the RM.
- The RM calculation then reflects that the transferee insurer puts in place longevity reinsurance in line with the insurer's management action, as the circumstance for doing so is deemed to have been triggered (as part of de-risking the assets).
- The Management Action Solution provides an alternative basis for calculating the RM, including a charge for longevity reinsurance that reflects the availability and cost of reinsurance based on observable prices and the time taken to purchase the longevity reinsurance. The Management Action Solution does not reduce the RM to zero.

Other proposals

- The EC CfA asks EIOPA to assess the appropriateness of the design of the RM, without challenging the approach based on the Cost of Capital. Some fundamental changes to the framework that nonetheless comply with this requirement are as follows:

Proposal: Change to the Level 1 RM definition retaining the CoC approach

Using the advice given by EIOPA to take a "through the cycle" approach to avoid procyclicality, the value of the RM could be deliberately smoothed over time.

The RM is based on a cost of capital approach for non-hedgeable risks, which currently includes mass lapse risk. For a number of products (eg unit-linked products without surrender guarantees), the fact of having a large part of the own funds financed by future profits, results in a large mass lapse risk SCR because, under a mass lapse, those profits would be lower. In the context of the RM it does not make sense for the loss of profits to increase the RM because neither the current shareholder nor a third party taking over the portfolio would have to invest capital to cover the risk. If there is no capital investment, there can be no cost of capital and as such there is no RM relating to this risk.

Proposal to exclude mass lapse risk from RM calculations under specific conditions

To the extent that it can be shown that the amount of mass lapse risk corresponds to a positive value of future profits in own funds, mass lapse risk should not be part of the risks leading to a cost of capital for the assumed reference undertaking in Art 38-39 of the DA, ie mass lapse risk should in those cases be reduced or excluded from the RM calculation.

4. Own funds

The industry welcomes EIOPA's acknowledgement of the differences between the insurance and the banking sectors, and the corresponding advice <u>not to align the tiering structure to banking regulation</u>.

The industry disagrees with EIOPA's analysis of the concept of "<u>double leverage</u>" and notes that Solvency II already provides for the elimination in group solvency of the double use of eligible own funds and of the internal creation of capital.

The industry agrees with EIOPA's draft advice to not change the treatment of <u>EPIFPs</u> but does not agree that further work is needed. EPIFPs are an important part of the Solvency II framework allowing the reflection of economic reality, with respect to the principle of going concern. As such, they are a useful element, notably to encourage the offer of long-term guarantees. EIOPA seems to regard a positive value of EPIFPs as something negative that should be limited, which is a conservative approach and is contrary to the Solvency II principle of going concern. EIOPA should not undermine EPIFPs by limiting their eligibility or downgrading their tiering.

Section 4.2 Tiering and ancillary own funds

- Paragraph 20: The industry welcomes EIOPA's analysis regarding the differences in the banking and insurance business models, and how they justify the differences in the tiering approaches between the two sectors.
- Paragraph 32: The industry supports EIOPA's view to not question the eligibility of nDTA as own funds, considering that it would be inconsistent with a calculation of LAC DT.
- Paragraph 34: The industry agrees with EIOPA analysis of the classification of nDTA. Indeed, the classification of nDTA in Tier 3 instead of Tier 1 is inconsistent with the fact that LAC DT directly reduces the SCR when a variation occurs and creates an asymmetry. Therefore, nDTA should be classified as Tier 1 (see comment on paragraph 42).
- Paragraph 40: The industry agrees that DTA should in any case be recognised as an own fund item.
- Paragraph 42: The industry notes that this paragraph is theoretical, in the case where the co-legislators would decide to align the tiering structure of Solvency II to the banking framework against EIOPA's advice.
  As highlighted by EIOPA in paragraph 35, undertakings must demonstrate the justification of nDTAs to the satisfaction of their supervisor. Therefore, there would be no rationale to limit the eligibility of nDTAs to a certain percentage of the SCR or of own funds.
  The justification to allow DTA in own funds is that a market-based regime is volatile. At times of market stress (losses), DTA are a buffer that reduces the impact of the losses on "equity". Allowing for such a buffer within a reasonable limit (currently up to 15% of SCR, classified as tier 3) is an appropriate tool to limit the volatility of Solvency II.
  However, in order for the buffer to be fully available when it is needed (a time of crisis), own funds from DTA must not be grouped together with other own funds (sub debt T2 or T3) for purposes of limit calculations.
  First, it should not be allowed for insurers to use a "volatility" buffer (DTA) in "good" market conditions (no losses) for the issuance of sub debt, which then means that at times of crisis any increase of DTA due to losses may not count as own funds if the combined headroom limit is already fully used by sub debt. (no buffer in that case).
  Second, at times of a significant crisis, it may only be possible to issue T2, and not RT1. However, at times of crisis a significant "surprise" increase of DTA may fully cannibalize the remaining headroom limit for T2, thus preventing the insurer from increasing its own funds via sub debt.
  There would be no need to reclassify DTA into T2 if T3 were to be deleted. Instead, DTA should be classified in UT1. As long as the eligibility of DTA in UT1 is subject to a maximum limit (eg 15% of SCR), there would be no need to classify it in a lower tier. DTA represents an asset which is subject to scrutiny before it can be recognised on the market value balance sheet. Provided that the amount of DTA in own funds is transparent,

market observers would have all necessary information for a proper assessment of the quality of own funds. The tiering limits for sub debt (RT1, T2) could be reduced to avoid that treatment of DTA as proposed by us increases the total limit for sub debt in total own funds.

- Paragraph 45: There would be no justification to disallow subordinated loans from eligible own funds, since EIOPA highlights that these fit the definition of tier 2 items in the banking framework. This would increase the detriments of such an unjustified harmonisation.
- Paragraph 67: The industry agrees with EIOPA's assessment that there are large differences in the business model between banks and insurance companies. Therefore, regulatory requirements cannot be exactly aligned. It is right and important that industry-specific characteristics are taken into account. In particular, insurers' ability to provide long-term products and guarantees should not be undermined.
- Paragraph 68: The industry welcomes EIOPA's advice to not change the Solvency II Tiering structure.

Section 4.3 Undue volatility

- Paragraph 83: The statement seems incorrect. PLAM increases UT1 by the post-tax write-down or conversion amount. In the current regime, RT1 is limited to 25% of UT1 (or 20% of Total T1). If, prior to write-down, the issuer had both excess RT1 and T2 (ie available RT1 and T2 exceeds the maximum limits), PLAM will increase the total amount of eligible capital. In fact, PLAM can only lead to an increase of the SCR ratio because of the current tiering limit system, and only because it helps to reverse generally unwanted procyclical effects. Therefore, changing the regime would affect the impact of PLAM.
- Paragraph 93: The industry welcomes EIOPA's advice that the RT1 limit should remain unchanged.

Section 4.4 Clarity of availability criteria

- Paragraph 103: The industry disagrees with EIOPA's analysis to consider as "double leverage" the fact that a parent undertaking in a group invests in Tier 1 instruments issued by a subsidiary (see detailed comment on paragraph 112).
  A regulated participating (re)insurance undertaking will typically not use senior debt instruments to finance its operations.
  The proposal is not clear in terms of which financing operations between a parent and its subsidiaries would be considered as potentially problematic (back-to-back loans mirroring external debts?) and the scope is likely to be too extensive and not proportionate to the identification of excessive situations.
  The double leverage ratio concept as outlined by EIOPA is ill defined and raises many questions.
  First, if the parent is an unregulated holding, it does not formally hold any T1 own funds. It is unclear whether unregulated HoldCo's would therefore be exempt from the obligation of a double leverage ratio. If a double leverage ratio concept were to be introduced, the industry sees no reason why a (re)insurance parent company should be required to calculate it, whereas an unregulated HoldCo parent would not. In fact, the industry understands that the main motivation of the double leverage ratio may have been private equity buyers located outside the EEA who acquire one or more EEA based (re)insurers, and finance their acquisitions with significant amounts of debt. If so, this should be made clear, and the double leverage ratio should only apply to such cases.
  Second, if the parent holds an equity stake in an unregulated HoldCo, and that HoldCo in turn holds an equity stake in a regulated (re)insurance subsidiary, it is unclear whether the parent's stake in its direct subsidiary (unregulated HoldCo) would count as a relevant "T1 own funds investment" of the parent. If it would count as a "T1 own funds investment", would the entire participation in the unregulated HoldCo count, or only that proportion of this participation value that relates to the HoldCo's own "T1 own funds investments" in regulated subsidiaries?
  Third, where some of the parent's (re)insurance subsidiaries themselves hold stakes in one or more (re)insurance subsidiaries, it is unclear whether there would be a need to calculate double leverage ratios both for the ultimate parent as well as for each of those subsidiary (re)insurers that own stakes in other (re)insurers.

- Paragraph 104: For many unlisted entities, issuing a debt instrument or subordinated liabilities is the only possibility to obtain external capital.
- Paragraph 110: The industry notes that under the Solvency II framework, it is already the responsibility of undertakings to assess and manage any arising liquidity risk, as it is the case for any other risk. Adding a specific requirement is consequently unnecessary, and listing some risks that should be monitored may be detrimental to sound risk management, as it may place a focus on some immaterial risks instead of ensuring a risk-based approach.
- Paragraph 112: The industry disagrees with EIOPA advice to fix a limit on a "double leverage ratio" above which supervisory actions should be taken (see comments on paragraphs 103 & 110).

  Any "excessive leverage" would become apparent in the consolidated market value balance sheet, and any risk arising from the financing of subsidiaries should be monitored by group risk management, as any other risk. Group supervision automatically limits the extent of double leverage as all solo own funds that are "created" internally are cancelled out via consolidation (an equivalent approach avoids double use of own funds under Method 2). A high degree of double leverage would show in a weak group solvency ratio. The "double leverage ratio" therefore does not add value other than in extreme special circumstances (eg where the parent company is located outside the EEA, ie cases where no relevant group regulation applies and where there is no effective limit to double leverage).

  The suggested addition of a supervisory intervention point for group supervisors if the "leverage ratio" within the holding company of a group is above 100% is not warranted, since Solvency II ensures that legal entities within the group are appropriately capitalised and can function on a stand-alone basis. The argument that the parent undertaking may be unable to service debt, in the (extreme) case that participations do not pay dividends, does not substantiate a requirement to have participations only financed through equity, since (in extreme cases) the participation can be sold. On the contrary, capital and dividend management in a holding context is well established and has been functioning well without such constraints.

  It is unclear why such extreme hypothetical cases should give rise to a general change in law. Moreover, if a very peculiar and special case were to pose a threat to the financial position of the group or its undertakings, both solo NSAs and group supervisors would already have power to take appropriate measures (eg Art. 258 Directive).

  A double leverage constraint would be excessive and overlooking the "availability" assessment, which ensures that own funds within the group are free from encumbrances and available (as per Art. 330 of the Directive). If tier 1 own funds of affiliates are assessed as available to the group, the double leverage concern is not relevant. The policy proposed would force alignment of external and internal funding mixes, foregoing legitimate reasons for applying senior and hybrid debt financing for the group. It would constrain the financing of groups with tier 2 or tier 3 debt considering that in many jurisdictions (such as the US), it is not always possible to down-stream tier 2 or tier 3 debt and equity financing is the only option including for fiscal reasons. Diversification benefits at the level of the ultimate parent should be allowed to be financed with senior debt, or else the diversification benefit granted by the delegated regulation will be impaired for the group. It creates a perverse incentive (more senior debt) to internally finance (re)insurance undertakings with more debt instead of reducing the external debt.

  In any case, supervisors ultimately already have tools to prevent distributions from (re)insurance undertakings, protecting policy holders. Therefore, the industry considers that the current rules are sufficient and operating well. Solvency II already provides for the elimination in group solvency of the double use of eligible own funds and of the internal creation of capital (Art. 222 and 223 of the Directive). As such, the proposed change is not necessary.

Section 4.5 Correct attribution of items

- Paragraph 141: The industry supports some NSAs' view that positive EPIFPs should not be considered as a negative thing. EPIFPs are an output of the economic valuation of the BEL (ie the present value of expected *future* cash flows) and the level of EPIFPs depends on each undertaking's risk profile (ie there is no "good" or "bad" levels of EPIFPs per se). EIOPA should not try in the future to limit the eligibility or downgrade the tiering of elements such as EPIFPs, which are a useful tool for insurers to offer long term guarantees.
- Paragraph 143: The industry agrees with the argument that losses affecting technical provisions have immediate loss absorbency. Consequently, the main concern is a stress scenario where cash is needed, eg in case of a financial loss, that does not affect technical provisions. It should be noted however that most of the products that generate a high EPIFP are subject to the life underwriting risk stresses, which typically manifest themselves over a length of time, throughout which the EPIFP becomes available. Looking only at the small set of scenarios where cash is needed, the EPIFP would not deteriorate and could thus be made available using reinsurance or a portfolio sale. A market exists for both types of transactions. Due to the competition in the reinsurance market and regulatory restrictions in the calculation of EPIFP (eg contract boundaries) the reinsurance commission received could conceivably be even higher than the profits accounted for in the EPIFP.

  A reinsurance agreement could be set up within a period of up to 9 months. A 9-months period is appropriate as this is consistent with the requirement for the availability assessment of own fund items at group level according to Article 330 1c) of the Delegated Regulation.
- Paragraph 151: The industry supports EIOPA's argument to consider that NSAs have the responsibility to monitor and assess the accuracy of the calculation of EPIFPs. The current framework already allows for sufficient supervisory powers to achieve that purpose.
- Paragraph 152: The industry does not share the view that the changes in the calculation of EPIFPs as outlined in the "section 3 – Technical provisions" of the consultation paper would result in less volatile estimated EPIFPs, it would be quite the contrary (see previous comments).
- Paragraph 153 : The proposal to allow for capital add-ons related to EPIFPs is inconsistent with the very concept of capital add-ons and that of the market value of the Solvency II balance sheet. Capital add-ons have been designed to address gaps in the SCR calculations. EPIFPs arise from the calculation of the BEL and supervisors are granted power to review BEL calculations, methods and assumptions. This lapse risk for EPIFP is already accounted for in the SCR as part of the lapse modules for life, health and non-life. Thus, there is no need to impose any additional capital add-ons for lapse risk associated with EPIFP. The rationale for capital add-ons on the BEL seems therefore very unclear in that it is silent on the type of issues in the derivation of the BEL which cannot be remedied with existing supervisory powers.
- Paragraph 160: The industry welcomes EIOPA's advice to not change the attribution of EPIFPs to Tier 1. EIOPA should not try in the future to limit the eligibility or downgrade the tiering of EPIFPs, which are a useful tool for insurers to offer long term guarantees.

Q4.1: What is your view on the treatment of EPIFPs?
- The treatment of EPIFPs should not be changed. As highlighted by EIOPA, positive EPIFPs should be regarded as a good thing. They are a useful tool for insurers to offer long term guarantees, and as such their eligibility or tiering should not be altered.
- The EPIFP is available to absorb losses: if the asset suffers a loss in its own value it is as such directly absorbing this loss by itself. To cover operational losses (eg in the underwriting result) any asset must be sold or monetised to compensate for the loss in cash. Similarly, the EPIFP can be made available to generate cash, through transactions such as sale of legal entities, portfolio transfers, reinsurance arrangements and securitisation. The timeframe for the completion of these transactions in six to nine months is realistic. There is no evidence that EPIFP should not be attributed to tier 1. The same is true in a group context: there is no indication why EPIFP should represent an own fund item of lower quality than any other asset.

- The industry agrees with the argument that losses affecting technical provisions have immediate loss absorbency (paragraph 143). Consequently, the main concern is a stress scenario where cash is needed, eg in case of a financial loss, that does not affect technical provisions.
  In this case the EPIFP would not deteriorate and could thus be made available by using reinsurance. While buyers might be difficult to find, there would be a range of reinsurers, that could provide the required coverage. Due to the competition in the reinsurance market and regulatory restrictions in the calculation of EPIFP (eg contract boundaries), the reinsurance commission received might be even higher than the profits accounted for in the EPIFP.
  A reinsurance agreement could be set up within a period of up to nine months. Such a period is appropriate as this is consistent with the requirement for the availability assessment of own fund items at group level according to Article 330(1)(c) of the Delegated Regulation.
- Moreover, a relegation of EPIFP in the tiering limits would have significant effects as mentioned by EIOPA. It would also result in relegations of total own funds because tier 2 + tier 3 must not exceed 50% of the SCR. For those insurers having a sizable DTA, the remaining room within tier 2 is only limited to 35% of the SCR (since DTA are limited to 15% of the SCR). Having EPIFP in tier 2 would almost close the door to issuing tier 2 capital, therefore seriously limiting the ability of insurers to (re)finance themselves. This would significantly impair insurers' ability to offer long-term products and guarantees.
- The industry supports EIOPA's argument to consider that NSAs have the responsibility to monitor and assess the accuracy of the calculation of EPIFPs. The current framework already allows for sufficient supervisory powers to achieve that purpose. Putting an arbitrary limit to EPIFP would be detrimental to the offer of long-term guarantees, and would have an adverse impact on insurers who issue profitable contracts, which is counterintuitive and would not reflect economic reality.
- The industry further notes that EIOPA makes a reference to the contractual service margin recognised within IFRS 17. However, the fundamental principles of IFRS and Solvency II are not the same. One of the more fundamental differences is that Solvency II considers the exit value, while IFRS assess the fulfilment value.
- EIOPA's proposal to not change the treatment of EPIFPs is welcome. The industry does not see a need for further work in this area.

5. Solvency Capital Requirement standard formula

The current capital requirements for market risk do not properly reflect the real economic risks to which insurers are exposed. The industry is disappointed by EIOPA's advice on the calibrations of standard formula submodules.

EIOPA's proposal on the recalibration of interest rate risk is based on overly theoretical and hypothetical views on how low interest rates can go. Also, EIOPA's use of factor-based stress for the extrapolated part of the interest rate term structure is economically incorrect and creates an inconsistency with the calculation of the liabilities. Its proposals would create excessive capital requirements.

Negative rates are a reality. There is, however, no evidence that the extreme levels of negative rates implied by EIOPA's methodology are justified or even possible. Any change to the current interest rate SCR methodology needs to include a floor which reflects the reality of negative rates without hypothesising about the future and also consider the impact on the business model. It is equally important that the shock is only applied up until the last liquid point.

The industry supports the extension of the dynamic volatility adjustment to the standard formula to resolve the incorrect treatment of corporate bonds within Solvency II. A decrease of the property risk shock to better reflect the underlying risk based on pan-European data is supported.

The lapse risk submodules need revision because they are set too high and exclude contracts which, in reality, would have a mitigating effect. The correlation parameter between interest rate down risk and spread risk should also be reduced to reflect the evidence presented by EIOPA.

On risk mitigation, the industry is disappointed that EIOPA has not proposed potential solutions to address the flaws in the current standard formula relating to non-proportional reinsurance and basis risk.

On counterparty default risk, the industry supports policy option 3 which EIOPA's own analysis identifies as the most technically correct and least burdensome. It is therefore surprising that EIOPA has opted to support policy option 2 which is incorrect and creates a higher calculation burden for insurers.

Section 5.1 Interest rate risk

The industry opposes all EIOPA's proposed calibrations of the standard formula interest rate shock.

- There are two key deficiencies with EIOPA's proposed formulation; 1) the level of the effective lower bound of interest rates in the model and 2) the use of factor-based stresses for both the liquid and extrapolated parts of the interest rate term structure.
- As noted in response to section 2.2, industry does not support the extension of the last liquid point for the Euro RFR curve. Consequently, it does not support the proposed extension to the interest rate risk stress factors which reflect the proposed extension to the Euro LLP.

Effective lower bound of interest rates in the model

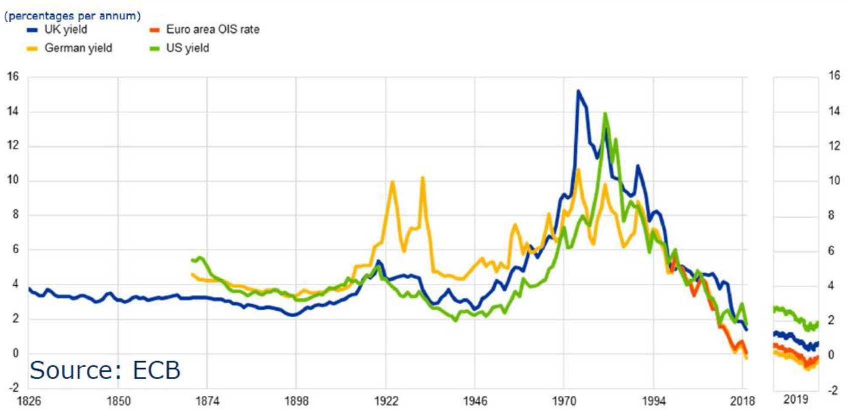
The impact of any changes to the interest rate SCR must be considered when calibrating the model. It is of great importance that any exaggeration in the capital requirement for interest rate risk is avoided in order not to endanger financial stability and the important role of life insurers not only in the supply of long-term guarantees but also in the long-term financing of the European economy.

The existing standard formula stresses were designed in a period of relatively high interest rates. At that time, it was widely accepted that there was a zero-lower bound on nominal interest rates and the zero-floor in the standard model was considered to be a sensible bound to the down shocks. Experience since then has shown that the calibration of the down stresses when interest rates were higher was not severe enough and that the zero rates are not the lower bound.

However, any analysis of historical interest rates shows that the current market environment is exceptional. This is clearly demonstrated in the chart below, sourced from the ECB, which shows the evolution of long-term rates over a c.200 year period. The future path of interest rates is clearly unknown; however, it is evident that the declines experienced over the past 10 years cannot be repeated over the next 10 years. This holds in particular because a large proportion of recent interest rate declines were only caused by ECB's interventions. According to the ECB itself, the unconventional measures taken by the ECB have lowered the level and slope of the yield curve to a level that would otherwise not have been possible. However, the prohibition of monetary financing and the resulting limits per emission by no means allow repeating the volume of asset purchases made so far. Thus, at the low interest rate level achieved by the previous interventions, no further reduction of a similar magnitude is possible under the current legal situation.

Chart 1

UK, US, DE and euro area OIS long-term interest rates



Moreover, if interest rates would fall too deep and/or too long in the negative area, insurers would have to retreat from fixed income investments and switch to a combination of real assets and hoarding large amounts of cash. Therefore, an excessive calibration of interest rate risk does not make sense.

Therefore, there are both economic and political reasons why the interest rate SCR should not be over calibrated. Any model of interest rates must contain a reasonable floor which reflects the lower bound of interest rates. Experiences with interest rates changes in times of positive rates cannot be transferred in an unlimited way into phases with substantially negatives rates. The model must also result in a diminishing capital requirement as it approaches the model floor.

In EIOPA's model, the shift vector creates an implicit floor to the model. If prevailing market interest rates approach the level of the shift vector the capital requirements diminish towards zero. **However, EIOPA has based its shift vector on the lowest rates experienced in the Swiss Franc market minus a significant margin for prudence. This results in a floor which is too low and consequently creates excessive SCRs in the low and negative yield environment.**

Use of factor-based stresses for the extrapolated part of the interest rate term structure.

EIOPA's model uses factor-based stresses for the extrapolated part of the interest rate term structure. This is economically incorrect and creates an inconsistency with the calculation of the liabilities; should the prescribed 1 in 200-year stress materialise, only the liquid part of the curve would be affected, the illiquid part of the curve would then be derived using the extrapolation methodology. Therefore, the stress scenario proposed by EIOPA to determine capital requirements is inconsistent with the valuation framework.

This deficiency was highlighted by all the main stakeholders, including the IRSG and Actuarial Association of Europe, who responded to the EIOPA consultation on the 2018 Review of Solvency II. In contrast to the EIOPA proposal, these stakeholders supported an interest rate risk methodology which is consistent with the valuation of liabilities and determines the illiquid part of the stressed curve through extrapolation.

A post-shock extrapolation methodology is also permitted for internal model firms under Article 121 (2) of the Solvency II Directive which states that methods used are "consistent with the calculation of technical provisions". This effectively requires internal model users to extrapolate the illiquid part of the post-shock interest rate curve. As the deviation of modelling approaches between the standard formula and internal models for interest rate risk was one of EIOPA's key rationales for changing the approach, it is unjustified not to accept this approach to deriving the illiquid part of the stressed curve.

The logical correct order (first stress of market data, then extrapolation based on the results) also avoids the false shock of the UFR associated with EIOPA's proposal. Note that even according to EIOPA's planned reduction of the UFR, the annual change of the UFR is restricted to just three possibilities: +15 bp, +/−0 bp or −15 bp. Moreover, the direction of a possible UFR change is known in advance. If the UFR changes in the next year at all, then – depending on the data – either a change of +15 bp or a change of −15 bp may be conceivable, but never both at the same time. This has to be properly reflected in the design of the interest rate risk module.

Stressing and extrapolating in the logical correct order also has the important advantage that the interest rate risk module fits automatically to all different values of the LLP. Thus, there is no need for different proposals depending on the LLP. There should be a single calibration of risk factors. For the euro, it is applied up to the euro LLP (currently 20 years), for currencies with other LLPs just up to their specific LLP. Then, in each case, extrapolation sets in. This avoids the disadvantage of EIOPA's proposal which applies risk factors of the "wrong category" (either based on market data or tailored for the extrapolation area) to non-euro currencies with a different LLP than the euro LLP.

Industry views on the future development of the interest rate risk SCR submodule

Industry recognises that a relative shifted approach model could be used as an alternative to the current approach to capture the risk of negative yields. It agrees with EIOPA that it is relatively simple, transparent and data driven.

However, any updated interest rate risk model must be calibrated and designed to:

1. **Contain a floor which properly reflects the extent to which yield curves can go negative and the true risk in a low and negative yield environment**
2. **Extrapolate the illiquid part of the yield curve using standard extrapolation parameters and methodology.**
3. **Be appropriate for all currencies to which it is applied.**

Furthermore, it appears that whatever the calibration will be, such a change will have a significant impact on solvency ratios. So, any changes to the interest rate risk submodule should be jointly considered with other changes. Potential impacts must be carefully assessed and phased in over time.

Industry ideas on interest rate risk

Idea 1 – recalibrated relative shift approach and add a safety mechanism

The industry proposes to replace the current standard formula interest rate risk submodule shocks with a relative shift model.

The model uses term-dependent shift parameters up until the LLP. The illiquid part of the shocked curve is then derived using the shocked input data, extrapolation parameters consistent with the base case (UFR, convergence speed) and the Smith-Wilson methodology.

The calibration of the shift parameters and stress factors are designed to reflect the industry's views of the effective lower bound for interest rates. Furthermore, the proposal also includes a "safety-mechanism" to ensure that there will always be a capital requirement (minimum 0.25% decrease), should the market test the model's implicit lower bound.

Formulae (for liquid part of the curve)

The increase in the interest rate at maturity m is given by

$$r_t^{up}(m) = r_t(m) \cdot (1 + s_m^{up}(\theta_m)) + b_m^{up}$$

The decrease in the interest rate at maturity m is given by

$$r_t^{down}(m) = min\{(r_t\,(m) - 0.25\%), (r_t(m) \cdot (1 - s_m^{down}(\theta_m)) - b_m^{down})\}$$

where

- $r_t(m)\ is\ the\ risk - free\ interest\ rate$
- $s_m^{up/down}, b_m^{up/down}$ are the calibrated maturity dependent up/down shift components.

Calibration of shift parameter

- The up-shift parameter is consistent with the proposal put forward by EIOPA in the consultation ie a shift parameter of 3.5% across all tenors.
- The down-shift parameter is maturity dependent and is based upon the industry's view of a realistic lower-bound for interest rates. The shift parameter is -1% at 1-year and decreases linearly to 0% at 20 years.

The above choice of shift parameter produces lower stresses in a low-yield environment relative to EIOPA's proposal. This is consistent with the view that there is an effective lower bound to the yield curve and there should be diminishing capital requirements as the yield curve approaches the lower bound.

Stress factors
Based on the chosen shift parameters, the industry has calibrated the 99.5% stress factors, based on 20 years of EUR data.

The resulting shift components are provided in the table below.

Maturity, m	s_m^{up}	b_m^{up}	s_m^{down}	b_m^{down}
1	61%	2.14%	64%	0.64%
2	53%	1.86%	55%	0.52%
3	49%	1.72%	48%	0.43%
4	46%	1.61%	47%	0.40%
5	45%	1.58%	51%	0.40%
6	41%	1.44%	53%	0.39%
7	37%	1.30%	54%	0.37%
8	34%	1.19%	54%	0.34%
9	32%	1.12%	55%	0.32%
10	30%	1.05%	56%	0.29%
11	30%	1.05%	57%	0.27%
12	30%	1.05%	58%	0.25%
13	30%	1.05%	59%	0.22%
14	29%	1.02%	61%	0.19%
15	28%	0.98%	62%	0.16%
16	28%	0.98%	63%	0.13%
17	27%	0.95%	64%	0.10%
18	26%	0.91%	66%	0.07%
19	26%	0.91%	67%	0.04%
20	25%	0.88%	68%	0.00%
50	20%	0.00%	30%	0.00%
Extrapolated curve	Term structure of the illiquid part of the curve derived using Smith-Wilson methodology and extrapolation parameters which are consistent with the base case.			

Any parameters not detailed in the table above, should be linearly interpolated.

Idea 2 – introduce an explicit floor to EIOPA's proposal
The industry proposes an improved version of the EIOPA proposal in the consultation. It introduces an explicit floor to EIOPA's model for the downward risk to reflect the industry's views on the effective lower bound for interest rates. Note that this proposal uses EIOPA's shift components and stress factors.

The model uses term-dependent shift parameters up until the LLP. The illiquid part of the shocked curve is then derived using the shocked input data, extrapolation parameters consistent with the (UFR, convergence speed) and the Smith-Wilson methodology.

Formulae (for liquid part of the curve)
The increase in the interest rate at maturity m is given by

$$r_t^{up}(m) = r_t(m) \cdot (1 + s_m^{up}(\theta_m)) + b_m^{up}$$

The decrease in the interest rate at maturity m is given by

$$r_t^{down}(m) = max\{(r_{floor}(m) - 0.10\%), (r_t(m) \cdot (1 - s_m^{down}(\theta_m)) - b_m^{down})\}$$

where

- $r_t(m)\ is\ the\ risk-free\ interest\ rate$
- $s_m^{up/down}, b_m^{up/down}$ are the calibrated maturity dependent up/down shift components **as calibrated by EIOPA in the consultation.**
- $r_{floor}(m)\ is\ the\ lowest\ risk-free\ interest\ rate$ recorded for the Euro curve for maturity m plus 10 basis points margin for prudence

Floor

The current floor is given by the lowest monthly EIOPA RFR curve of all time. Currently, the low is shown at end-August 2019 and is given by the following parameters for the EUR curve (inc. the 10 basis points margin for prudence).

Maturity, m	r_{floor}
1	-0.70%
2	-0.76%
3	-0.77%
4	-0.75%
5	-0.73%
6	-0.69%
7	-0.64%
8	-0.58%
9	-0.53%
10	-0.48%
11	-0.43%
12	-0.38%
13	-0.32%
14	-0.28%
15	-0.26%
16	-0.24%
17	-0.23%
18	-0.21%
19	-0.19%
20	-0.14%

Paragraph 13: The industry disagrees. The backtesting results for the up-shocks in Table B are not in line with the expectations according to a 99.5 percentile shock. The number of breaches in the non-extrapolated part of the term structure is far too low.

Paragraph 15: The industry disagrees. The backtesting results show that the calibration of the up-shock is overshooting.

The two tables below summarise the results of the backtesting of the up and down stress and covers a total of 9*21=189 backtests for each stress. Since the proposed calibration methodology always ensures a perfect match of the expected number of breaches for the universe of data points used to calibrate the interest rate down stress, those 13 points do not contain any information, and effectively there are 176 backtests conducted for the interest rate down stress. The tables have been colour coded according to the description below.

Table B – Up Shock Breaches per Currency and Maturity

Currency	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	12Y	15Y	20Y	25Y	30Y	35Y	40Y	45Y	50Y	55Y	60Y
EUR	0	0	0	0	0	0	0	0	0	0	0	1	1	56	102	110	110	110	110	110	114
HUF	22	12	22	22	22	22	22	22	22	22	22	13	17	19	20	12	10	9	9	9	10
GBP	0	0	0	0	0	0	0	0	0	0	0	0	0	0	3	10	38	62	84	128	160
SEK	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
HRK	0	0	0	0	0	0	0	2	3	5	4	11	10	10	4	2	2	0	0	0	0
CZK	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PLN	0	2	0	0	2	0	1	0	0	2	3	22	22	13	12	8	5	3	3	3	5
CHF	0	25	0	0	0	0	0	0	0	0	0	6	13	33	28	13	5	5	6	16	37
NOK	0	0	0	0	0	0	0	0	0	0	1	2	3	3	3	3	3	3	3	3	3

Table C- Down Shock Breaches per Currency and Maturity

Currency	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	12Y	15Y	20Y	25Y	30Y	35Y	40Y	45Y	50Y	55Y	60Y
EUR	25	25	25	25	25	25	25	25	25	25	25	25	25	4	0	1	1	1	1	1	2
HUF	0	0	45	58	36	35	35	35	21	15	15	17	2	4	9	9	10	11	13	20	22
GBP	115	51	20	0	1	10	36	32	17	7	1	0	0	0	13	53	73	100	148	176	193
SEK	138	99	72	80	73	79	87	75	69	46	0	0	0	0	0	0	0	0	0	0	0
HRK	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
CZK	0	0	0	0	0	0	0	0	0	0	2	3	0	0	0	0	0	0	0	0	0
PLN	0	2	0	18	19	33	61	47	22	18	16	11	3	2	2	2	2	2	2	2	2
CHF	0	66	128	90	55	76	104	102	99	100	89	64	35	50	20	1	0	0	0	0	0
NOK	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Colour coding: yellow=too few breaches, white=too many breaches, pink=calibration universe interest rate down stress

Too few breaches mean that the defined stress is too severe, too many breaches mean that the defined stress is too lenient. It is clear that in an overwhelming majority of the cases, the proposed stresses have been too severe. It can therefore be concluded that the proposed stress does not work well for non-euro currencies and for the euro above 20 Y. In addition, there are problems of how the number of breaches should be interpreted. For example, all breaches for SEK 1 Y relate to one event, namely the drastic decrease of the interest rate around the Lehman failure during the fall of 2008. Thus, the breaches are clustered and not spread out as required when performing this kind of evaluation of the model and parameters. Therefore, it is not correct to conclude that as there are many breaches for SEK 1 Y the stress is not severe enough.

Paragraph 16: The risk factors shall only be applied to the liquid part before the LLP (currency dependent). Then the usual extrapolation algorithm shall be applied to extrapolate the illiquid part of the stressed curves from their liquid parts. This is the only way to derive consistent, risk-sensitive and economically sound stressed risk-free curves in the illiquid part of the term structure and the only way to compute the true loss in basic own funds. Complexity is not at all increased by this.

Paragraph 21-22: Calibrating the interest rate risk shock using euro data with a 30y or 50 y LLP will exacerbate the existing issues for non-euro currencies, such as the Swedish krona. The problems with EIOPA's proposal will be more severe for these currencies if the EUR LLP is 30 or 50 years and not at all consistent with reality.

Section 5.2 Spread risk

The industry is disappointed by EIOPA's advice in this area. **EIOPA fails to propose any improvements that would support bond/loan investment and the EC CMU project**.

The industry supports the extension of the DVA to the standard formula (option 4) to resolve the incorrect treatment of corporate bonds within Solvency II.

This approach is already implemented by many internal model firms who model market risk and could be easily implemented for standard formula users by EIOPA providing the VA adjustments that standard formula companies should use under the SCR spread shock scenario. This will ensure that the capital requirements for corporate bond exposures for all insurers are more reflective of the true economic risks. The industry notes that the introduction of the dynamic VA in the Standard Formula would not and should not impact the 0% risk weighting for Member State sovereign debt.

The dynamic volatility adjustment does not change the risk measurement of the asset side but ensures that the total balance sheet approach of Solvency II is obeyed, ie that assumed spread changes are adequately reflected in the risk measurement of liabilities as well the assets. This is consistent with the standard formula calculations for interest rate and currency risk where the off-setting effects between assets and liabilities are modelled.

In section 2.4.7, EIOPA has provided an overview of how the DVA could be implemented in the standard formula. Industry provides below its assessment of how the DVA could be implemented.

As a starting point, industry notes that a pre-requisite of the implementation of a DVA approach in the standard formula is that it should result in positive risk management outcomes and deter poor risk management and that there should also be no change in the scope of calibration of the spread risk submodule. Furthermore, industry agrees with EIOPA (para. 2.578) that the use of a dynamic VA should be optional.

There are different ways that the dynamic VA could be implemented in to the standard formula. For example:

- EIOPA provides information to calculate a dynamic VA
  - For representative portfolio VA: EIOPA provides a dynamic VA (calculated using SF stresses)
  - For Own Assets VA: EIOPA provides stressed spreads to allow undertakings to calculate Own Assets dynamic VA
- Overlay risk management safeguards on dynamic VA to prevent wrong risk management incentives and perverse outcomes (eg negative capital requirements for spread risk).
- Recalculate the technical provisions using the dynamic VA and offset impact of dynamic VA from spread risk submodule.

Paragraph 47: The use of a DVA-approach is consistent with the 1-year VaR metric and with the total balance sheet approach of Solvency II (see Recital 45 of SII Directive) and the specific requirement to calculate the spread risk component of the standard formula as the sensitivity of the value of **assets and liabilities** to change in the level or volatility of spreads (see Art 105. 5(d) SII Directive).

Paragraph 53-55: Despite acknowledging that insurers who provide long-term products and invest long-term are not exposed to spread risk, EIOPA provides no analysis of the default/downgrade risk to which these insurers are exposed.

Paragraph 61-68: The industry further recognises that in option 2 and option 3, EIOPA is attempting to better reflect the real, lower underlying risk of investment in corporate bonds. The industry does not believe that the proposed criteria are able to fit insurance ALM practices. There are a number of flaws identified including:

- The criteria are based on those which were designed for the introduction of the long-term equity risk submodule, the same issues regarding the identification and separate management of the portfolio of bonds and the average holding periods will be encountered (see response to section 2.9 for more details).
- The EEA requirement restricts the ability of insurers to diversify which is contrary to the interest of policyholders.
- Any reference to bonds used as part of ALM strategic investment mixes is not included. In principle, the ALM defines the strategic asset mix and which in their turn defines the ability of insurers to invest in bonds/loans etc. including the necessary risk profile. In particular, the assignment requirement is not consistent with the ALM practices.

Paragraph 65 and 67: The industry does not agree with EIOPA that the reduction factors detailed in Article 181 should be altered. The criteria set out above are sufficiently robust to ensure that the insurer is not exposed to forced sales and as such should benefit from the reduction factors of Article 181.

Paragraph 66 and 68: The industry agrees with EIOPA that its proposed option 2 and 3 would support the EC's CMU objectives. However, it does not agree with EIOPA's assessment of the cons of these approaches:

- Creating more correct capital requirements for bonds and loans which back liabilities and are not subject to the risk of forced sales does not deviate from the fundamentals of Solvency II, namely the 99.5% confidence level nor the 1-year time horizon.
- There is evidence to show that default risk is lower than spread risk which supports the reduction in spread risk charges for bonds and loans which back liabilities and are not subject to the risk of forced sales.
- There is no evidence to support the hypothesis that the correct capital treatment of long-term investments would result in a race to the bottom of capital charges.

Paragraph 69-70: The industry considers the following pros and cons of the extension of the DVA into the standard formula:

Pros:

- It could support the EC's CMU objectives
- Ensures correct reflection of the total balance sheet approach of Solvency II
- Simple and transparent to implement
- Consistent with 1-year 99.5% VaR metric
- Ensures capital requirements for corporate bond holdings are economically justified
- Does not require the development of a set of distinct set of criteria to identify those bonds/loans which are held for long-term

Cons:

- None

Paragraph 71: In the evaluation of options it is assessed whether fixed income investments are dis-incentivised. This is not the appropriate question since assets that support the capital markets union objectives are specific sub-assets within the fixed income domain. Furthermore, too little attention is spent on the underlying maturity of the investments. In order to support the capital markets union long-dated assets will be especially relevant.

Section 5.3 Property risk

The industry supports a recalibration of the property risk submodule charge and welcomes EIOPA's investigation of a more appropriate shock not solely based on UK data (policy option 7).

- The European insurance industry encourages EIOPA to adjust the property risk factor as soon as possible. In the current framework, calibration is based mostly on UK data, which most likely results in too high stresses for properties in some countries. As identified by EIOPA, there are structural differences in property markets. Consequently, a pan-European single common shock cannot be solely based on UK commercial property market which is exceptionally volatile and by no means representative for a typical European insurer's real estate investment. Therefore, the property risk should be recalibrated with appropriate data from other European property markets. The European Commission should be provided with definitive advice implying a change to the current approach.
- AN MSCI / INREV report published in March 2017 (see link here: https://www.msci.com/documents/10199/239004/MSCI+Real+Estate+Solvency+II+2017+Update+Report/136d5292-c850-4485-b187-94b1218bc626) clearly showed that the risk factor of 25% is too high and that an appropriate risk factor for the entire European property market would be 15% at most. For a European composite excluding the UK the risk factor should not exceed 12%. The industry considers the available data for the pan-European real estate market to be sufficient for recalibrating the standard formula property risk factor.
- Paragraph 81-106: Even if the industry understands that data scarcity is a limitation of EIOPA analysis, it encourages EIOPA to disclose its preliminary evidence regarding the risk profile of property, as this could provide a preliminary indication of the appropriateness of the Solvency II risk shock for property risk.
- Paragraph 107-108: **In line with the evidence above, the industry believes that the shock for real estate risk across the European Union should be set to a value of 15% at most.** This calibration is based on a European real estate portfolio (instead of UK commercial property only). Even if EIOPA wants to continue its analyses, existing results should already be considered in the 2020 review and their acknowledgment should not be postponed to an uncertain later date.

Q5.1: Do you know data sources which would help to better calibrate property risk?

The European insurance industry considers the MSCI/INREV data to be an optimal publicly available data source. The analysis of the MSCI / INREV report published in 2017 calculates an appropriate risk factor based on data for the European real estate market (see link here: https://www.msci.com/documents/10199/239004/MSCI+Real+Estate+Solvency+II+2017+Update+Report/136d5292-c850-4485-b187-94b1218bc626).

Section 5.4 Correlation matrices

Q5.3: Do you consider that the correlations within market risk, as well as the correlation between lapse risk and market risks should be amended? If your answer is "yes", you are invited to provide quantitative evidence supporting your reasoning

Industry supports a reduction in the correlation parameter between interest rate down risk and spread risk to 0. EIOPA's empirical analysis, detailed in figure 2 and figure 3, does not support the retention of the 0.5 correlation parameter between interest rate down risk and spread risk.

When interest rates are extremely low or even negative – as in the interest rate risk down scenario – there is no strong correlation between interest rates and an increase in spreads. The analysis below demonstrates that the correlation between interest rates and credit spreads during the last 12 months (when interest rates were in a very low environment) are lower than those envisaged by the standard formula and supports a reduction in the correlation parameter.

The analysis shows the observation of the daily interest rate trend with respect to the daily trend of 4 indices that summarise the credit spread of different segments of the corporate bond market. This analysis distinguishes the correlations between (1) the cases in which the daily changes in interest rates are negative (decrease) from (2) the cases in which these changes are positive (increase).

- The correlations between the increase in interest rates and the increase in spreads was (averaging the surveys on the 4 spread indices) -0.32 (against 0.00 of the SF).
- The correlations between the decrease in interest rates and the increase in spreads was on average +0.02 (against +0.50 of the SF) meaning fundamentally independence.

Data: Creditworthiness indicators (Itraxx) for various segments of the EU corporate bond market. The series covers 12 months and refers to the period December 2018 - November 2019.

Reference: the Swap rate at 5Y as it is consistent with the average duration of the underlying assets to the iTraxx indices.

The following are the specifications relating to the iTraxx indexes:
* iTraxx Crossover: 75 Most Liquid High Yield corporate Credit Default Swaps (average B + rating);
* Main Europe: 125 Most Liquid Investment Grade corporate Credit Default Swaps (average rating BBB +);
* Senior Financials: 30 Senior Credit Default Swaps for Banks (average rating A-);
* Subordinated Financials: 30 Subordinated Credit Default Swaps for Banks (average BBB rating)

a. iTraxx Crossover

Interest rates go up

	Δ Cross	**Δ int_rate**	Cross&Int_rate
mean	- 2,210	1,486	
variance	41,407	1,801	
mean square error	6,435	1,342	
covariance			- 2,291
correlation			-26,53%
check			OK

Interest rates go down

	Δ Cross	**Δ Int_rate**	Cross&Int_rate
mean	0,908	- 1,454	
variance	43,735	1,802	
mean square error	6,613	1,342	
covariance			- 0,629
correlation			-7,09%
check			OK

b. Main Europe

Interest rates go up

	Δ Main	Δ int_rate	Main&Int_rate
mean	- 0,576	1,486	
variance	2,945	1,801	
mean square error	1,716	1,342	
covariance			- 0,824
correlation			-35,78%
check			OK

Interest rates go down

	Δ Main	Δ Int_rate	Main&Int_rate
mean	0,201	- 1,454	
variance	3,460	1,802	
mean square error	1,860	1,342	
covariance			0,050
correlation			2,02%
check			OK

c. Senior Financials

Interest rates go up

	Δ Sen Fin	Δ int_rate	SenFin&Int_rate
mean	- 0,853	1,486	
variance	5,135	1,801	
mean square error	2,266	1,342	
covariance			- 0,933
correlation			-30,67%
check			OK

Interest rates go down

	Δ Sen Fin	Δ Int_rate	SenFin&Int_rate
mean	0,306	- 1,454	
variance	6,766	1,802	
mean square error	2,601	1,342	
covariance			0,192
correlation			5,49%
check			OK

d. Subordinated Financials

Interest rates go up

	Δ Sub Fin	Δ int_rate	SubFin&Int_rate
mean	- 1,650	1,486	
variance	25,018	1,801	
mean square error	5,002	1,342	
covariance			- 2,284
correlation			-34,02%
check			OK

Interest rates go down

	Δ Sub Fin	Δ Int_rate	SubFin&Int_rate
mean	0,592	- 1,454	
variance	26,554	1,802	
mean square error	5,153	1,342	
covariance			0,705
correlation			10,20%
check			OK

Section 5.5 Counterparty default risk

Overall, industry is disappointed that EIOPA has not considered a more fundamental simplification of the structure of the counterparty default risk submodule, as requested by the EC. The evidence put forward by EIOPA in the 2018 Review supports a simpler approach to the modelling of counterparty default risk within the standard formula.

However, industry welcomes the proposal to introduce a simplified calculation of the risk mitigating effect of derivatives, reinsurance arrangements, SPVs and insurance securitisations. It also welcomes EIOPA's proposal to extend the effective recognition of partial guarantees of mortgage loans.

Regarding the hypothetical calculation of the fire, marine and aviation SCRs, industry supports policy option 3. In its assessment, EIOPA notes that policy option 3 "creates the correct assessment of the RMre and minimises the calculation burden for undertakings". It is therefore unclear why EIOPA prefers policy option 2 which leads to a less correct result.

- Paragraph 183: The insurance industry continues to support policy option 3**,** to specify that in the calculation of the hypothetical SCR in the counterparty default risk submodule, the largest identified risk concentration for the fire, marine and aviation risk submodules should not be impacted by the non-existence of the reinsurance arrangement.
- The identification of the largest risk concentration can be a huge effort for small and medium sized undertakings. It is possibly based on expert judgement. Therefore, it is advisable to not alter the identification of the largest risk concentration. The same base, ie the net base, can be used for the computation of the SCR in the cat module and for the risk mitigation effect in the CDR module. This assessment would be consistent and correct. It is questionable why EIOPA prefers option 2, which, on one hand, leads to a less correct result and, on the other hand, creates additional burden as the SCR calculation for the cat module would be required on a gross and net basis to calculate the CDR.
- Paragraph 200: Industry disagrees with the proposal to move the loans from the spread risk module to the CDR module. This would be against the current methodology. Rather, where deemed necessary, EIOPA should introduce a new spread category.

Section 5.6 Calibration of underwriting risk

The insurance industry supports both a recalibration of the lapse risk parameters for both life and non-life insurance as well as the extension of the USP framework to cover lapse risk. Moreover, in the life lapse risk scenarios the change in option exercise rates should apply to all contracts.

In its 2009 advice, CEIOPS proposed a mass lapse calibration of 30% for retail business and 70% for non-retail business. (CEIOPS' CP49 on the Mass Lapse from October 2009). These calibrations were used in the QIS 5 exercise but were subsequently increased to 40% for retail business prior to the implementation of Solvency II.

Industry has previously highlighted that the calibration of these factors is unduly onerous and does not reflect insurers' experience.

- Currently, lapse risk in life insurance is only selectively applied to those contracts for which the increased or reduced lapse increases the obligations for the insurance company, ie for which a higher reserve would have to be set aside if the risk materialised. In practice, however, it can be observed that the movements in lapse rates and decreases are largely homogeneous across all portfolios. Article 142 of the Delegated Regulation should therefore be adapted in such a way that the lapse changes simultaneously affect all insurance contracts, irrespective of whether this increases the technical provisions or not.

- When calculating the capital requirement for mass lapse risk, any changes in the risk margin are excluded. This means that in a mass lapse scenario it is assumed that the cost of holding capital for future mass lapse risk remains unchanged, despite the loss of customer-base (and future profit). It would be more correct to re-calculate the risk margin when calculating the capital requirement for mass lapse risk, thus reducing the mass lapse stress accordingly.

  For the sake of simplicity and to avoid circular calculations, the risk margin is kept constant in all stress scenarios of the standard formula. In case of the mass lapse risk, this is clearly inappropriate. Therefore, a pragmatic solution could be to lower the mass lapse risk factors accordingly.

  Profitable unit-linked products result in high lapse risk, and a high-risk margin. This is especially the case for products that will be charged 70 %. An unintentional consequence of this might be that many companies are considering, or already have bought, mass lapse reinsurance. Mass lapse reinsurance is mainly considered to be a capital measure, which drives up costs. A re-evaluation of the risk margin and mass lapse for unit-linked products is therefore necessary.

- Academic analysis supports industry's request for a recalibration of the mass lapse parameter. See Biagini et al (2019); Estimating Extreme Cancellation Rates in Life Insurance[10]

It is also worthwhile highlighting that the proposal to grant NSAs with the power to impose a temporarily freeze on redemption rights in exceptional circumstances would also justify a recalibration of the mass lapse parameters.

As well as supporting a recalibration, industry has advocated for the extension of the USP framework to lapse risk, as was foreseen in the Solvency II directive. In our response to the consultation on the 2018 review, we provided a concrete proposal to extend USPs to cover lapse risk which was rejected by EIOPA.

[10] Estimating extreme cancellation rates in life insurance

Proposal to use Vasicek Credit Loan Portfolio Model to calibrate the Mass Lapse risk submodule

One of the main reasons that the mass lapse scenario is one of the most controversial in the standard formula is due to the fact that there is no underlying model. If a model would be introduced, the discussion around advantages, deficiencies and the final value of the stress would be more effective.

Ideally, the model would calibrate a shock based on the scarce data available and capture the persistency characteristics between different products. The industry believes such a model is available, namely the Vasicek model, used in the Basel framework to calculate stressed default probabilities for credit risk.

The Vasicek model assumes that both a systematic risk and a client specific risk drives the default event of loan. The systematic risk can be described as a major event causing several loans to default; for example, a financial crisis, extremely high unemployment rates or an upwards shock to the interest rate.

The Vasicek model contains attributes that are intuitive for modelling lapse rates. Lapse event of one policy, similarly to loans, reasonably depends on both a systematic and non-systematic risk. Through the cycle lapse probabilities are easily obtained, as these can be estimated based on the historical lapse rates.

Further information on the Vasicek model can be found on the Bank of England paper, Modelling Credit Risk by Somnath Chatterjee.

Section 5.7 Catastrophe risk

As noted in the industry's response to the 2018 Review, industry is sceptical about the extent to which EIOPA's proposed ex-post adjustment will address the issue that some undertakings' policy conditions are significantly lower than those which have been assumed in the calibration of the natcat parameters.

The industry continues to contend that a number of the natcat country parameters have been incorrectly calibrated and are not reflective of the vendor model output, including the Italian and Greece earthquake risk country factors. The excessive calibration of these parameters is contributing to the perception that the average policy conditions are not properly taken into account.

- Paragraph 217: Greater transparency about the data and assumptions for calibrating the natural hazards of storms, hail, floods and earthquakes is necessary. This is necessary to examine the modelling of natural catastrophe risk in a first step, and in a second, to discuss concrete adjustments to the standard formula in order to model the risks more appropriately.
- Paragraph 221: The industry would appreciate further information and transparency regarding the members and work of the Technical Expert Network on Catastrophe Risks established by EIOPA in early 2019. There are some undertakings that are particularly exposed to natural hazards and have very long-standing expertise in this area. It would be desirable if (more) representatives of these undertakings could become a member of this Network in order to ensure the flow of information for the undertakings and provide expert advice.
- Paragraph 223: The industry asks EIOPA to publish the results taken from the template. The market average conditions of the policy conditions (contractual lower and upper limits) can be useful information for undertakings. The data enables an assessment for each undertaking whether it deviates from the market average conditions.
- Paragraph 225: The results from the template should be considered carefully because some changes of the template have taken place since its initial publication. The change of "% of average TSI" to "% of TSI" has an impact on the outcome as well as the adjustment of the lower and upper ends to be interpreted as the 1st and 3rd quartile, respectively. The answer in form of the Q&A is only published on 26/11/2019 and is most likely not seen by many undertakings.

Section 5.8 Risk mitigation techniques

- Paragraph 231: In the context of financial risk-mitigation techniques, the implications of the Solvency II Directive for netting agreements have to be considered in particular. This is unfortunately missing in the consultation paper and should be added.
  Netting of derivatives is standard as a recognised risk mitigation technique for financial transactions in Europe and netting agreements are privileged in the European CRR and EMIR regulations in particular because of their risk mitigating effect. Insurers also use netting to reduce risk and protect their liquidity. Unfortunately, Art. 275 (1a) of the Solvency II Directive makes it more difficult to conclude netting agreements for the guarantee assets. Art. 275 (1a) stipulates that the claims of the insured have priority over all other claims. This absolute priority over claims by third parties, which was implemented at national level by an absolute ban on offsetting, is contrary to the conclusion of netting agreements. Against this background, an exception to the absolute priority in Art. 275 (1a) Solvency II is required for netting agreements.
  Art. 275 (1a) Solvency II should be supplemented to the extent that absolute priority does not apply to netting agreements and a corresponding exception at national level does not violate the Directive. This addition could be worded as follows: "The order of absolute precedence under subparagraph (a) of this provision shall not preclude the set-off of claims in the context of netting in derivatives and securities lending transactions."

Basis risk

- Paragraph 5.293:

While the Solvency II Directive defines basis risk and a guideline exists on basis risk, the industry is aware of situations where application is unclear and divergent regulatory practice exists.

EIOPA points out two issues in its draft advice:

- Guidelines on basis risk cannot be used as a legal basis to object to undertakings' use of certain risk-mitigation instruments: the industry believes that there is no intrinsic reason why the criteria described in the guidelines on financial risk mitigation techniques could not also apply to insurance risk-mitigation techniques. However, the industry understands that the objective of the guidelines is to provide clarification on aspects relating to material basis risk without entering into excessive detail or prescriptiveness. While there may be valid reasons to modify the guidelines, the industry does not support the transcription of the unmodified guidelines into the delegated regulation.
- Use of reinsurance for standard formula stress events: EIOPA is concerned about disproportionally increased risk reduction which can result in a capital requirement that would be insufficient at less severe stress scenarios. The industry understands that this concern has arisen in the context of non-proportional reinsurance. The statement appears to contradict insurers' freedom to retain part of the risk in the form of a deductible. The industry accepts the notion that in extremis, a shock equal to the amount of the deductible would provide the insurer with capital relief without earnings relief – however, this is no different to any other form of non-proportional reinsurance, or indeed to any form of primary insurance that features a deductible or indeed other mechanisms by which the beneficiary retains part of the risk. Where insurers' capital requirements are determined by the standard formula stress scenarios, it is legitimate that insurers assess the effectiveness of their risk-mitigation measures on them.

The industry considers the current rules under Solvency II for basis risk to be unclear in two respects:

- How to interpret the existing guidelines on basis risk in the reinsurance context.
- How an identified basis risk can/should be quantified.

Inconsistencies in these aspects impact the recognition of reinsurance treaties under Solvency II.

The industry believes the current application is failing to meet the objectives of Solvency II:

- Harmonisation: There is divergence among the individual regulators on what constitutes basis risk and how it should be quantified.

- Effective risk management: The exclusion of high-quality risk mitigation techniques from insurance companies' risk management toolkit is limiting their ability to transfer insurance risks to reinsurers. This issue is compounded by an unwillingness to explore risk mitigation due to the uncertain outcome of potential regulatory review.
- Efficient insurance market: as a result of these real and perceived restrictions, insurers are retaining risk and capital that may otherwise be desirable to transfer to reinsurers in a mutually beneficial transaction.

- To address the issues discussed above, the industry proposes the following changes to the Guidelines on basis risk (EIOPA-BoS-14/172):
  - Proposal 1: extend treatment of material basis risk in the delegated regulation
    - Article 86 specifies a treatment for material basis risk in currency mismatch. It is not clear why this particular kind of basis risk is deserving of special treatment and mention in the delegated regulation. The industry proposes striking the mentions of currency risk and the specific treatment for currency mismatch from article 86. The appropriate place for any provisions on currency risk is in the guidelines along with the other relevant considerations on basis risk.
    - Article 86 would therefore read:

    Article 86 Material Basis Risk

    Notwithstanding Article 210(2), where insurance or reinsurance undertakings transfer underwriting risk using reinsurance contracts or special purpose vehicles that are subject to material basis risk between underwriting risk and the risk-mitigation technique, insurance or reinsurance undertakings may take into account the risk-mitigation technique in the calculation of the Solvency Capital Requirement according to the standard formula, provided that the risk-mitigation technique complies with Article 209, Article 210(1), (3) and (4) and Article 211 and the undertaking has made an appropriate deduction for the material basis risk.

  - Proposal 2: Scope of the guidelines
    - The guidelines on basis risk provide in 1.4 state that:

    These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement for market risk under Solvency II.

    - The industry believes that this statement could mislead the reader to believe that the Guidelines are only concerned with market risk. Guideline 3 is explicitly dedicated to insurance risk-mitigation, therefore the industry suggests that 1.4 should instead read:

    These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement under Solvency II.

    - Guidelines 1.10 to 1.12 should therefore also apply in the case of Insurance risk-mitigation techniques with no material basis risk.

  - Proposal 3: the assessment of basis risk should take into account the threshold as well as the cap
    - The guidelines on basis risk in Guideline 2 1.12 state that:

    Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection as a proportion of the initial exposure, undertakings should apply the assessment only to the proportion covered by the risk-mitigation technique when determining whether the basis risk is material.

- The industry believes that this provision should reflect the existence of thresholds as well as caps in insurance risk-mitigation techniques. Therefore, 1.12 should read:

  Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection, undertakings should apply the assessment only to the part covered by the risk-mitigation technique when determining whether the basis risk is material.

  Where the terms and conditions of a risk-mitigation technique specify that the risk-mitigation technique is activated after certain thresholds are exceeded, undertakings should base their assessment on whether the basis risk is material on those scenarios in which the thresholds are exceeded.

- Proposal 4: the existence of material basis risk in a cover should be corrected for in the capital relief provided
  - Solvency II rules have a principles-based definition of material being something that "could influence the decision-making or judgement of the intended user of that information, including the supervisory authorities". If the basis risk can be quantified, one could look at the solvency ratio difference with and without the basis risk adjustment and test whether the difference would result in significantly different decisions by internal/external stakeholders. This test would determine whether the basis risk is material or not and its extent.

  - The industry requests that where an insurer is able to quantify the basis risk in a cover and such basis risk is established to be material, the insurer should be able to subtract the extent of the basis risk from the benefit of risk mitigation under the standard formula, while still being able to recognise the remaining capital relief for the remaining part. The industry considers this a preferred alternative to the approach described in EIOPA Q&A 1597.

  - The industry suggests that the following text is added to the Guidelines:

  Where a risk-mitigation technique does not satisfy the conditions listed in Guidelines 1, 2 and 3, ie there is material basis risk, and the undertaking is able to appropriately quantify the extent of such basis risk, the risk-mitigation technique may be reflected in the calculation of the Solvency Capital Requirement with the standard formula, provided it is reduced by the amount of material basis risk.

- Proposal 5: expansion of the explanatory text to the Guidelines
  - The industry suggests that section 2. "Explanatory text" of the Guidelines is expanded to include examples relating to Guidelines 1.9, 1.10, 1.12, 1.13 of situations with basis risk and of situations not constituting basis risk.

Q5.4: What is your view on the recognition of non-proportional reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals. How does the proposal address the double counting issue regarding non-proportional reinsurance covers between the CAT risk sub-module and other sub-modules impacted by treaties?

The Reinsurance Advisory Board has sent two papers to EIOPA on this subject and exchanged views on several occasions.

Non-proportional (NP) reinsurance is the predominant risk mitigation instrument for the non-life sector and a crucial tool for smaller and medium sized companies to manage peak risk.

The current form of the Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (in the following referred to as "Delegated Act") provides for a flat 20% reduction on the volatility of premium risk for three lines of business.

This reduction does not depend on the actual existence of reinsurance and is not available for other lines of business, nor for reserving risk. Concerning the recognition of various types of cover within the catastrophe risk module EIOPA has issued Guidelines (EIOPA-BoS-14/173, Guidelines on the application of outwards reinsurance arrangements to the non-life underwriting risk sub-module,), which allow for a principles-based application of complex reinsurance treaties. Thus, more risk-sensitive approaches are generally available within the Solvency II framework.

While the standard formula recognises the impact of NP reinsurance in the Catastrophe sub-module of the non-life underwriting risk module of the SCR, it can be improved in the premium and reserve risk sub-module. The industry considers this to be a technical inconsistency of the standard formula that needs to be addressed in the 2020 review.

The industry welcomes EIOPA's openness to discussing methods to improve the recognition of non-proportional reinsurance with the industry. However, a balance will have to be struck between risk-sensitivity, complexity, and prudency. The industry is conscious that the architecture of the standard formula places limitations on what is practically achievable. Expanded recognition can be a solution to handle shortcomings of the current approach without jeopardising simplicity and prudency of the same.

Principles for the recognition of NP reinsurance

In general, the industry recommends that the following principles should be the basis for an expanded reinsurance recognition:

1) The adjustment factors for non-proportional reinsurance (described in Article 117(3) of the Delegated Act) should be calculated to reflect the risk mitigating impact of non-proportional reinsurance for all classes of business, subject to meeting the criteria listed here.
2) The adjustment factors for non-proportional reinsurance should be risk-sensitive, reflecting the particulars of the reinsurance arrangements in place.
3) The assessment of the risk-mitigating impact of non-proportional reinsurance should be broadly based on the impact on own funds of a gross loss scenario equal in magnitude to the gross factor-based capital charge derived using the standard formula [The capital charge for premium and reserve risk equates to the impact of a premium and reserve risk stress event at the 99.5th confidence interval over 1 year (then aggregated with other similarly calibrated risk charges within the non-life underwriting risk module)].
4) There should be no double counting of credit for a particular reinsurance arrangement.
5) The adjustment factor for non-proportional reinsurance should only be applied in respect of reinsurance arrangements that meet the criteria for risk-mitigating techniques in Articles 209 to 213 of the Delegated Act.
6) The assessment of the impact of non-proportional reinsurance on gross losses in the premium and reserve risk module should be coordinated by the competent function within the (re)insurance undertaking and should be subject to a review process within the undertaking.
7) Any approach should be proportional and accessible to small and medium-sized undertakings and should not dilute the risk mitigating effect of the current approach.

The industry explores below ways in which an appropriate gross loss scenario can be derived in order to determine the non-proportional reinsurance impact.

Approach 1: SAM approach

The approach that is closest to the principles-based nature described above is that taken by South Africa's Solvency Assessment and Management framework (SAM) regime, therein referred to as 'RM_{other}'. This methodology would allow proper recognition of non-proportional non-life reinsurance in the premium and reserve risk module, both at the level of individual lines of business as well as whole account covers. This approach is the preferred option of the industry since it is used - as a conscious deviation from Solvency II - in a proven regulatory framework close to Solvency II.

While generally striving for Solvency II equivalence, the South African regulator has identified adjustments for risk mitigating instruments as an area where the SAM system should differ in approach from the Solvency II standard formula and allow for stop loss and other reinsurance structures for risk mitigation under RM_{SL} and RM_{other} respectively (FSB, Position Paper 78 (v 7.2) Non-Life Underwriting Risk: Structure and Calibration, 6.3 Conclusions on preferred approach). These RM_{SL} and RM_{other} components have been integrated directly in the calculation of the non-life underwriting risk requirement (see below) – (Prudential Standard FSI 4.3 Non-Life Underwriting Risk Capital Requirement, pp. 3-4). The prudential standard clearly specifies that these components allow for risk mitigation that is not allowed for elsewhere in the non-life underwriting risk module.

$$SCR_{NL} = \sqrt{\sum_{r,c} CorrNL_{r,c} \cdot NL_r \cdot NL_c} - RM_{SL} - RM_{other} + IMP_{SL\_Other} - ADJLoss_{abs} + SCR_{nl\_fp}$$

It is important to note that the definitions used in this approach ensure that double-counting of any capital benefit due to reinsurance with other modules of the standard formula does not occur.

The SAM approach allows for the recognition of covers affecting a single line of business as well as aggregate covers across lines. This is a clear advantage over the current approach based on non-proportional reinsurance adjustment factors, as these apply to a line of business basis and cannot account for aggregate covers.

Approach 2: simplified economic approach
This approach builds on the industry's proposals on Adverse Development Covers (ADCs) expanding them to both premium risk and reserving risk and addressing EIOPA's concerns about the application that were voiced in its advice to the Commission for the Solvency II 2018 review.

For the 2018 review, a CRO Forum working group proposed a methodology for recognition of Adverse Development Covers, submitted to EIOPA by email on 12.01.2018. The industry believes that there is no reason why the methodology would have to be changed conceptually to be valid for covers on premium risk [Please also refer to the industry response to the European Commission consultation on draft Solvency II 2018 review (Better Regulation Initiative)].

EIOPA raised a number of concerns with the proposed methodology. The industry believes most of these issues can be addressed by making changes to the formula. A revised methodology could include a factor E that would represent a prudence factor to counteract the effect of any double-counting on the reserve risk calibrations, as well as serve to make the method more prudent. As such, the formula presented for ADCs could be expressed as:

$$NP_{adj} = (A - (B - C) \times D \times E) / A$$

Definitions similar to ADC methodology presented as part of 2018 review
A: Impact on the basic own funds (BOF) of premium reserve risk scenario as defined under the SF = Nominal best estimate net reserves x Standard deviation for non-life gross premium or reserve risk of the segment x 3
B: ADC recovery under premium or reserve risk scenario = The lower of the following:

- Nominal best estimate net premiums or reserves covered by the reinsurance structure x (1 + 3 · σ(res,s)) – reinsurance structure attachment point
- Reinsurance structure cover size

C: Additional reinsurance premium or the equivalent thereof
D: Cession to the reinsurer in %
E: Prudency factor in %

Approach 3: USP-based adjustments to the standard formula
The basis of this proposed option is to implement the Solvency II undertaking-specific parameters (USP) approach directly into the standard formula as an optional calculation not requiring USPs and extending the methodology to reserve risk. The USP approach takes into account the specifics of the NP reinsurance contracts in place for each line of business and therefore respects Principle 3 mentioned above that the credit for reinsurance should be based on the impact on own funds of a gross loss scenario equal in magnitude to the gross factor-based capital charge. The attractiveness of this option is that it achieves this without making particular assumptions about the number of claims underlying the gross loss scenario.

The main characteristics of the proposal are the following:
- To extend the perimeter of the USP framework of possible NP Factor application by incorporating it in the standard formula;
- To introduce a more risk-sensitive method with respect to the 20% discount;
- To maintain consistency with the existing USP;
- To restore the balance between non-life standard formula insurers and life and/or internal model insurers, who are generally able to recognise non-proportional reinsurance.

The overall effect of the proposal is strictly dependent on the calibration/recalibration exercise and the choice of the respective parameters. On a general basis, the proposal accounts for an extension of the perimeter of LoBs and instruments allowable but it is also more risk-sensitive with respect to the LoBs (MVL, FDP and TPL).

Approach 4: Development of the current approach as an option
The current approach for NP reinsurance is a proportionate approach with low complexity. Further developments of the current approach have to be considered carefully as they could increase the complexity easily. The current level of recognition is considered to be overly limiting. In a discussion with the industry, EIOPA raised the idea of extending the adjustment factors for NP reinsurance to all LoBs, as well as to determine criteria for their application. EIOPA argued that it would consider this approach as an addition rather than an alternative to the approaches described above.

The implementation of this approach should be without prejudice to the parallel introduction of any of the other proposed approaches, which could be optionally used instead.

The industry recognises that it would still represent an improvement as compared to the status quo. Moreover, the industry accepts the logic that it may be necessary to introduce an additional approach to combat the inconsistency on the standard formula without introducing much complexity for companies who require a more accurate treatment of their non-proportional reinsurance programme at the cost of a more complex calculation.

Comparison
In the table below the industry tried to summarise the differences between the approaches with regards to the objectives and challenges in addressing the issue:

Approach	Risk sensitivity	Complexity	Prudency
Status quo	--	++	--
Approach 1: SAM approach	++	-	+
Approach 2: simplified economic approach	+	++	++
Approach 3: USP approach	++	-	++

Legend: ++ performs better -- performs worse

Any approach would be more **risk sensitive** than the status quo. The SAM approach or USP approach would be most risk sensitive, but at the potential cost of greater complexity relative to the simplified economic approach. Any approach would be **prudent**. The industry considers the simplified economic approach sufficiently prudent given the small deviations in EIOPA's past analysis of ADCs, which can be addressed. The USP approach described

is no less nor more prudent than the use of the same USP for premium risk reinsurance already requires and is thus considered sufficiently prudent. Using a combination of approaches could lead to a more positive outcome.

Q5.5: What is your view on the recognition of adverse development covers in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

The industry believes that adverse development covers would ideally be addressed as part of a broader solution for non-proportional reinsurance in the premium & reserve risk module, as described in question 5.4. Any of the proposed approaches would provide adequate recognition for ADCs as well as other covers. The industry would further refer to previous extensive input shared with EIOPA on ADCs.

Q5.6: What is your view on the recognition of finite reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

The concept of finite reinsurance has been introduced in 2005 to delimit a special category of reinsurance, which may require special monitoring due to a limited risk transfer. In order to avoid an abuse of such forms of reinsurance, the European Regulation required insurers to take special measures in risk management and the controlling of corresponding contracts and introduced special additional reporting requirements to supervisors.

Examples of "critical contracts" have been in the past, e.g.:

- Non-Life Reinsurance with limited liability due to e.g. claims dependent additional premiums (so-called spread loss reinsurance contracts)
- Transfer of undiscounted claim reserves with a predefined repayment schedule (so-called time and distance reinsurance contracts)
- Reinsurance contracts with loan character due to payback clauses

Under Solvency II such constructions are no longer possible:

- In general, the recognition of risk mitigation of reinsurance contracts is subject to the proof of an effective risk transfer (Article 210 of the Delegated Act).
- There is no need for special rules for reinsurance contracts, under which discounted cash-flows, e.g. an "explicit and material consideration of the time value of money" is relevant, since all reserves under Solvency II are to be discounted in any case. This includes the concept of "Reinsurance Recoverables", as it requires an economically correct valuation of all payments under a reinsurance contract, taking full account of any interest payments.
- The improvement of solvency ratios through reinsurance with a loan character (financings) is not possible under Solvency II, as all payments to the reinsurer are to be recognised on the basis of the "best estimate" in the solvency balance sheet. In addition, contracts with unconditional repayment obligations must also be accounted for and recognised as a future cash outflow.

Since most of the critical forms of finite reinsurance have already no effect in the solvency balance sheet due to the contract boundary concept and the consideration of the time value of money, a revision of the Solvency II rules may be reasonable in order to allow for a more target oriented regulatory framework. This refers to:

1) The definition of finite reinsurance (Article 210 of the Directive)
2) The recognition of finite reinsurance in the SCR standard formula (Article 208 of the Delegated Act)

To reflect the fact that under Solvency II the discounting effects are already considered appropriately, the reference to timing risk and the time value of money should be deleted from the definition of 'finite reinsurance'.

Article 210 (3) of the Solvency II Directive could be adjusted as follows:
"For the purposes of paragraphs 1 and 2 finite reinsurance means reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, exceeds the premium over the lifetime of

the contract by a limited but significant amount, and there exist contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer.”

Article 208(2) of the Delegated Act could be adjusted as well in order to better reflect the risk mitigating effect of finite reinsurance contracts.

Regarding the question on the recognition of finite reinsurance in the SCR standard formula, the industry understands the concerns of EIOPA that the recognition of some finite reinsurance contracts under the standard formula can result in a higher SCR relief compared to the risks transferred to the reinsurer. This is especially the case for proportional reinsurance with result dependent on conditions. In view of the large range of finite reinsurance contracts, where some of them still transfer significant risk to the reinsurer, the industry proposes a simple calculation method which takes account of this fact. This method allows the undertakings to get partial solvency relief for finite reinsurance depending on the insurance risks transferred.

For proportional reinsurance, the industry proposes a standard deviation approach which measures the ratio between the situation with and without loss mitigating features of result dependent conditions in an extreme loss scenario in comparison to the situation at the expected loss. The extreme scenario is defined as the expected loss plus three times the standard deviation of losses, which is taken as an approximation of the 200-year-event.

The numerator depicts the difference in reinsurance result between the expected loss scenario and the extreme loss scenario. The denominator depicts the difference in reinsurance results as before, but without loss mitigating features.

This defines the Allowance Ratio, which should be the basis for calculation of the solvency relief of a proportional reinsurance contract in the premium and reserve risk module of the SCR standard formula.

Allowance Ratio = (Reinsurance Result Ratio with loss mitigating features @ expected scenario - Reinsurance Result Ratio with loss mitigating features @ extreme scenario) / (Reinsurance Result Ratio without loss mitigating features @ expected scenario - Reinsurance Result Ratio without loss mitigating features @ extreme scenario)

Reinsurance Result Ratio = Reinsurance result / Reinsurance premium, calculated once at an extreme scenario and once at the expected scenario

Example: E(LR) 70% with a commission of 25%, standard deviation 5%, commission of 15% at a loss ratio of 85% (=70%+3*5%)

Reinsurance Result Ratio with loss mitigating features:
Reinsurance Result Ratio with loss mitigating features @ expected scenario: 100%-70%-25%=5%
Reinsurance Result Ratio with loss mitigating features @ extreme scenario: 100%-(70%+3*5%)-15%=0%

Reinsurance Result Ratio without loss mitigating features:
Reinsurance Result Ratio without loss mitigating features @ expected scenario: 100%-70%-25%=5%
Reinsurance Result Ratio without loss mitigating features @ extreme scenario: 100%-(70%+3*5%)-25%=-10%

Allowance Ratio:
Numerator: (Reinsurance Result Ratio with loss mitigating features @ expected scenario) less (Reinsurance Result Ratio with loss mitigating features @ extreme scenario) = 5% - 0% = 5%
Denominator: (Reinsurance Result Ratio without loss mitigating features @ expected scenario) less (Reinsurance Result Ratio without loss mitigating features @ extreme scenario) = 5% - (-10%) = 15%

Allowance Ratio = (5%-0%) / (5%-(-10%)) =33%

The calculation of this Allowance Ratio can be simplified to:
Numerator: Commission @ extreme scenario + 3 * standard deviation of loss ratio – commission @ expected scenario.
Denominator: The denominator corresponds to the difference in loss ratio scenarios, ie is three times the standard deviation, which is based on the fact that premium and commission should be constant for a contract without loss mitigating features.

Allowance Ratio: (15%+3*5%-25%) / (3*5%) =33%

Q5.7: If EIOPA would to recommend a consistent treatment of contingent instruments (contingent capital and convertible bond instruments) between standard formula and internal models, one possible way of implementing this principle would be to clarify that the definition of SCR (Article 101 of the Directive) does not include planned basic own funds increases. What do you think about this clarification?

Industry considers it would be inappropriate to align the Solvency II standard formula and internal models in this manner. In cases where a transaction genuinely improves the security of policyholders, it would not make sense to restrict the recognition of that benefit. Additionally, the proposed wording would have the unintended consequence of restricting the interpretation of the 1-year VaR for internal models.

A key feature of internal models is to provide flexibility to properly capture risk profile where standard formula cannot do so appropriately. Current regulation which allows the internal models to capture risk profile correctly and recognise the economic impact of contingent instruments under close supervisory scrutiny (via internal model approval processes) is appropriate and does not need to change. The differences that arise naturally between a one-size-fits-all standard formula and more advanced internal model methods should not mechanistically be seen as “inconsistencies”.

- Paragraph 241: the case presented here, as in EIOPA related Q&A (§ 5.233), is too general. In practice, the contract would be entered a Bank, so a regulated entity, and of very strong financial standing, whose commitment is firm, compulsory and irrevocable.
- Paragraph 273: The contingent capital facility has a direct impact on the Value-at-Risk of the basic own funds of the (re)insurer over a one-year period. Restricting the recognition of contingent capital in internal models would introduce bias in the reflection of the economic reality of the risk profile of (re)insurance undertakings.

Section 5.9 Reducing reliance on external ratings

- Paragraph 294: The industry highlights that the recent changes targeting internal assessments for unrated debt are very burdensome to apply in practice, not least because of the extensive criteria and the practical difficulties in assessing whether the criteria are met. The industry had cautioned EIOPA that an overly prudent approach to allowing the use of proxies for credit ratings may make proposals not workable in practice. The industry encourages EIOPA to investigate the success of those proposals by analysing the extent to which insurers make use of these provisions in practice and, if they don't, why this is so.
- Paragraph 296: Credit assessments are a key element of the Solvency II framework, for the calculation of the SCR, but not only. Development of internal credit assessments requires specific expertise, access to a wealth of internal information and ability to make use of economies of scale. Therefore, a number of insurers will continue to rely on external credit risk assessments.
- Paragraph 321: The industry agrees with EIOPA that it does not appear appropriate to extend the internal assessment approach introduced in Article 176a of the Delegated Regulation to rated debt. However, in order to reduce the reliance on external ratings, the industry is of the opinion that internal ratings that are considered by a (re)insurer as part of its approved internal model should in general be eligible for use in the standard formula calculations of entities that belong to the same insurance group (irrespective of whether the exposures are externally rated or unrated).
- Paragraph 322: The industry agrees with EIOPA's proposal to:
  - analyse the implementation of the provisions introduced in the Delegated Regulation that allow alternative credit assessments and
  - perform an impact assessment of future potential new methods for rated bonds.

  In addition, the industry encourages EIOPA to assess whether there is an appropriate approach that allows to use internal ratings that are considered by a (re)insurer as part of its approved internal model in the standard formula calculations of entities that belong to the same insurance group.

Section 5.10 Transitional on government bonds

6. Minimum Capital Requirement

The industry welcomes EIOPA's proposal not to change the calculation of the MCR corridor.

The industry disagrees with EIOPA's proposal to add specific requirements in relation to the ladder of intervention in case of risk of breach of the MCR. The NSAs already have sufficient powers to intervene when necessary so no additional provisions are needed. Preserving flexibility for NSAs' action is most likely in the best interest of policyholders.

As part of the simplification of Solvency II reporting, EIOPA should delete the template on reporting of notional MCRs for composite undertakings (template S.28.02.01). In fact, EIOPA's own analysis shows that this is of limited value, that it cannot be used properly by NSAs, and that deleting it would reduce the burden without jeopardising policyholders' interests.

Section 6.4 Calculation of the Minimum Capital Requirement

- Paragraph 21: On option 2, the industry welcomes EIOPA's acknowledgement that the reporting of life and non-life notional MCRs for composite undertakings is burdensome and unnecessary, as the information cannot be used properly by NSAs. The dismissal of option 3 to add more requirements is welcome.
- Paragraph 22: The industry welcomes EIOPA's advice to propose no changes to the MCR corridor calculation. Any change is unnecessary, considering that the definition of the new corridor (going back to QIS4) is expert judgment based.
- Paragraph 24: Considering EIOPA's analysis of the reporting of notional MCRs for composite undertakings (see comment on paragraph 21), it is unclear why EIOPA advises no deletion of this requirement. This is a missed opportunity to remove a requirement which is burdensome and has no clear benefit. Template S.28.02.01 should be deleted, and only S.28.01.01 should remain for all insurers.

Section 6.5 Non-compliance with the Minimum Capital Requirement

- Paragraph 34: The industry sees no need to clarify Art. 139 (1) of the Solvency II Directive. According to Art. 139 (I) "*insurance and reinsurance undertakings shall inform the supervisory authority immediately where they observe that the Minimum Capital Requirement is no longer complied with or where there is a risk of non-compliance in the following three months.*" Immediate reporting does clearly mean the undertaking should not wait until regular reporting is due. Moreover, the sentence "*where there is a risk of non-compliance in the following three months*" indicates that it is not necessary to assess the exact level of non-compliance. The existing provision is clear. Where NSAs choose different approaches contrary to the legislation, EIOPA should seek harmonisation through guidelines or provisions in the supervisory handbook. The harmonised approach should comply with existing regulation.
- Paragraph 43: The industry agrees with EIOPA that no changes to Article 139 (1) Solvency II Directive are needed regarding the qualification of risk of non-compliance.
- Paragraph 51: As stated in this paragraph, the CfA does not ask for advice on this topic. EIOPA describes in paragraphs 46 to 50 all the tools NSAs have at their disposal in case of risk of breach of the MCR. This shows that there is a number of possibilities, and some flexibility is beneficial for NSAs to adopt appropriate measures.
- Paragraph 52: The regulation provides that a financial scheme must be delivered by the undertaking within one month in case of breach of the MCR. The legal wording in Art. 139 (2) Solvency II Directive ("*from the observation of non-compliance with the Minimum Capital Requirement*") is clear. Non-compliance with the MCR coverage must be effective and therefore a breach should have occurred. In contrast to Art. 139 (1) Solvency II Directive, this is not about a risk of non-compliance in the following three months. It is concerning that EIOPA, under the guise of harmonisation or clarification, is seeking to shift the intervention threshold forward. If national supervisors choose different approaches contrary to the legislation, EIOPA should search

for harmonisation through convergence tools at its disposal, such as guidelines or provisions in the supervisory handbook. The harmonised approach should comply with existing regulation.

EIOPA highlighted in paragraphs 46 to 50 all possibilities NSAs have before the actual breach, when a risk of breach is detected. EIOPA's advice, which was not requested by the CfA, is not based on situations where NSAs have reported a lack of powers. Requesting a financial scheme before breach is both unnecessary and detrimental to other possibilities and good practice already at the disposal of NSAs. Furthermore, the content of the financial scheme should not be dictated by the regulation. Flexibility should be preserved in order to adapt to any individual situation so the financial scheme does not become merely a theoretical supervisory exercise with a template to fill in. The building of such a scheme requires in-depth self-analysis and the regulation cannot foresee all specific cases, in particular due to different national laws.

- Paragraph 53: Similar to comments on paragraph 52, the regulation should not seek to dictate minimum actions of NSAs in parallel to the requirement to provide a financial scheme. Flexibility needs to be preserved to adapt to every case and take into account differences in national insolvency laws.
- Paragraph 58: EIOPA points out in paragraphs 55 and 56 that most NSAs have at their disposal the possibility to prohibit the free disposal of assets, and choose to not make use of it in most cases. Moreover, EIOPA rightly highlights in paragraph 57 that the CfA does not require EIOPA's advice on this topic. Since no issue was reported, EIOPA's advice to change the regulation is not appropriate.

  The proposal would set a tight deadline for NSAs to consider one specific intervention measure of restriction or prohibition of the free disposal of the assets of the insurance or reinsurance undertaking, thereby unnecessarily depriving them of flexibility. This does not seem advantageous in view of the completely different courses and causes of crises, the severity of the intervention and the diversity and interactions of different supervisory measures. EIOPA should not attempt to impose restrictive measures at fixed deadlines, given the diverse nature of crisis situations. Regulation should preserve NSAs' adequate expert judgement.
- Paragraphs 70 & 71: The industry agrees that supervisory approaches regarding the extension of delay to restore the MCR should be harmonised, with a view to guarantee an equal policyholder protection among member states. The proposed amendment to Art. 144 (1) of the Directive that the deadline for the withdrawal of the authorisation could be extended in a specific situation is welcome. This would preserve flexibility for the completely different courses and causes of crises and the diversity and interactions of different supervisory measures.

7. Reporting and disclosure

The industry welcomes that EIOPA has stated in its earlier reporting consultation the intention to reduce the reporting burden. While there are some positive proposals, taken as a whole EIOPA's proposals will increase rather than decrease the overall burden.

On the QRTs the industry has the following views:

- **It welcomes that EIOPA has proposed deletion of a number of rarely used QRTs but other QRTs could also be deleted.**
- **It supports the proposal to allow for exemption of group reporting without the condition of exemption of all solo insurance undertakings belonging to that group.**
- **It disagrees with the proposals to introduce standard formula reporting requirements for internal model users, which are onerous , unnecessary and misleading.**
- **It disagrees with the proposed changes to a large number of existing QRTs, which would be costly and not justified by the supervisory benefits.**
- **Q4 reporting should be eliminated.**

For the SFCR:

- **The industry welcomes the removal of translation requirements for group SFCR.**
- **It strongly disagrees with proposals for new auditing requirements.**
- **It does not support the addition of various reporting and disclosure proposals which are spread across this consultation (eg on VA, risk management/disclosure provisions on LTG measures, best estimate and extrapolation).**
- **SFCRs should be simplified so that they consist of only a very short simple policyholder section and a simple data extraction of the public QRTs data without any set requirements for a narrative.**

On the RSR:

- **The default frequency of the RSR should be harmonised at 3 years and groups should have the option to produce a single group RSR. The industry is disappointed that its proposals in this area have not been included in the draft opinion.**
- **The industry does not believe the proposals to revise the structure and content of the RSR will reduce the burden and notes that some of the proposed reductions of the SFCR are simply moved to the RSR.**

Section 7.1 Introduction

- Despite the obvious fact that the cost of implementation of the changes and ensuring ongoing compliance with the requirements will be significant (considering the magnitude of changes across the reporting scope), it is difficult to have a clear view of the impacts of all the proposals in the area of supervisory reporting and disclosure because:
  - Reference is often made to proposals made in the consultation document of the first wave, making it challenging to properly assess the package as a whole.
  - EIOPA itself states several times that the content of this consultation paper does not entirely reflect the final version of EIOPA's proposals (eg in paragraph 7.73 it is mentioned that other proposals may result from the consultation on group solvency).
- Proportionality within reporting: As already highlighted by the industry in the July consultation on reporting, **more could have been done with regards to the application of proportionality in supervisory reporting**. This stands true also for the group reporting requirements. For example, proportionality could be enhanced by introducing reductions in group reporting where materially/substantially all group figures are mainly driven by figures and numbers of one large group solo entity. In such a case, all relevant and material information from a risk-based perspective would already have been obtained from the solo reporting.

- Paragraph 5: The reporting proposals regarding the VA, risk management/disclosure provisions on LTG measures, best estimate and extrapolation are exaggerated, and are adding a further burden to the already very extensive reporting requirements.
  - An overview of all these changes together is lacking, making it challenging to assess all the proposed changes in a consistent manner. Given that the consultation is a very extensive document, it is not always clear what the connections are and how the supervisory reporting is affected.
  - Reviewing the sections listed in the table, it is not always clear whether EIOPA proposes to add new QRTs/new sections to QRTs, or if EIOPA has only focused on identifying at this stage where some kind of new information would be needed but will elaborate a concrete proposal later on. EIOPA should provide clarity so that the industry can appropriately assess what is being proposed as a whole.
  - Regarding the reporting proposals for Best Estimate, more specifically on Expected profit from future premiums (including Expected losses and expected profits by LoB, impact of reinsurance on EPIFP, future profits embedded in fees from servicing and managing funds): it is not clear whether EIOPA effectively proposes to implement these reporting requirements or not, a clear proposal is not mentioned (see also para 3.62 and 3.63, where EIOPA mentions these proposals, but does not propose a template).

Section 7.2 Regular supervisory reporting

- Paragraph 21 – RSR Frequency
  - The **RSR frequency is still at the discretion of the supervisor**. A three-year RSR is sufficient and should become the standard, as opposed to simply being an option at the NSA's discretion. This would ensure clarity and a level playing field in the reporting requirements. During the other years no RSR reports should be requested, unless there have been material changes.
  - EIOPA's proposal for the possible mandatory assessment by NCAs and communication of the frequency of the RSR to undertakings is a positive development, as it promotes risk-oriented reporting and takes the individual situation of the insurer into consideration. However, it is not clear how it would work in practice.
  - Further, when the supervisor makes the assessment (as proposed by EIOPA) and obliges the insurer to report RSR more often than proposed, it is unclear from the RSR frequency proposal:
    - whether there is still a possibility in the future to report an abbreviated report (as foreseen in DA Art 312 (3), rather than a full RSR report.
    - what content a regular annual RSR submission would have.
- Paragraph 25 – RSR language requirements: The **industry proposes to include as an option to have English as the language requirement, at least for the Group RSR, but preferably also for the Solo RSR. To this end, the Level 2 Delegated Regulation should be amended. This would enable an international undertaking to have the option to submit the RSR only in English.**

  While EIOPA itself refers to stakeholder input in this area *("(...) many international companies prepare the reports in English and translate them into the local language for submission to the NSA. This creates additional expense and effort as all reports are prepared twice."*), it decided not to provide advice on the RSR language (as its advice is limited to proposals on RSR structure/content). In the wave 1 consultation (EIOPA-BoS-19-309_SFCR paragraph 67) EIOPA proposes to prepare the professional part of the SFCR in English and the two-pager document addressing the policyholder in the local language. Given that the SFCR and RSR are complementing documents, preparing them in different languages would unnecessarily complicate the process of compilation. International companies (as pointed out in the cited comment) prepare the RSR first in English and get it translated after or parallel to the compilation process of the English report, which is a very time-consuming and expensive exercise.

- Paragraph 27 – Similar to the proposals in the first wave, EIOPA proposes to have a machine readable and processable format for the RSR. The industry highlights that without any further details it is not possible to form an opinion on this. There should be a clear proposal subject to public consultation.
- Paragraph 29/Annex 7.1 (p835-866) – EIOPA's proposals to improve structure/content of the RSR
  - **While the industry takes note of EIOPA's intention to revise the structure and content of the RSR, it believes that this revision will not reduce the burden.** As noted in the response to the first consultation on reporting and public disclosure, the reporting requirements were not actually reduced, as information was simply moved from the SFCR to the RSR. In fact, in the current consultation the level of detail of the information required is actually increased.
    - There is no real correlation between EIOPA's stated intentions for the RSR (ie no repetition from other financial reports, use of the principle of proportionality, simplification) and the concrete proposals in the advice.
    - Throughout the Annex, EIOPA states several times that there is further need for granularity and detail, simply stating that "*more precise requirements are needed*", without further explanation.
  - The industry would also note that EIOPA has not addressed duplication of its RSR and SFCR reporting requirements with the information already contained elsewhere, such as within firms' ORSAs. Even though EIOPA has recognised potential overlap between the ORSA and RSR and would like to avoid duplication between these reports, it has made no concrete proposals on how this would be achieved in practice (see comments EIOPA provides in Annex 7.1 regarding Art. 308 System of governance point 4 p. 846-847.)

- Further, the proposal as described in Annex 7.1 is difficult to assess, the (often) conditional wording of the proposals leads to a lack of clarity and increases uncertainty. A proper assessment can only be made with full details and a comprehensive proposal. It is not clear whether EIOPA intends to keep only the full RSR report or whether it intends to maintain the option to have an abbreviated RSR (limited to material changes). In case EIOPA decides to go ahead with the moving of several sections of the SFCR to the RSR, it would only result in a reduction of the overall reporting burden if only the abbreviated RSR is to be reported.
- The industry is of the opinion that the RSR reporting requirements are already very extensive and the proposals of the current consultation add to this reporting burden by requesting further details.
- **The industry disagrees with the proposal to provide additional information, in particular in the area of remuneration** (e.g. remuneration entitlements of members of the AMSB and key function holders), as this adds to the already onerous reporting burden. Alternatively, to avoid the potential risk of confidential information being spread within the company or even getting public in the reporting process, which involves a multitude of people, **at least the option of a separate reporting of these data to the national supervisor (ie outside of the RSR) must be provided**.

- With respect to EIOPA's proposal - Annex 7.1 – RSR content proposal – Proposal to include also the main findings of actuarial function. ('*Actuarial function report is not obligatory sent to NCAs so it would be beneficial to see main findings from it in RSR. If the company sends actuarial report to NCA this requirement would not be applicable.* ')

  The industry takes note of EIOPA's justification and **it supports sending the actuarial function report to NCAs if requested, but it does not agree with the proposal to send only the key findings.**
  - First, the actuarial function report includes sufficient information to enable intended users to judge the relevance of the contents of the report and includes sufficient information, analysis and discussion to enable intended users to understand the implications of the conclusions of the report. In some cases, sending only main findings may not be sufficient to have an adequate understanding of the key messages.
  - Second, the actuarial function report has to be submitted to the AMSB, at least annually. However, there is no mention of a specific deadline and, depending on the company, this submission could have a different deadline as compared to the RSR submission process.

  Considering the above remarks, the proposal to include the main findings of the actuarial function report presents a risk:
  - to water down or to bias or to distort the opinion of the actuarial function and to not be compliant with the different actuarial association codes of conduct.
  - to constrain the actuarial function in a standardized timeline which could make this specific internal report drift towards a standardized report.

Section 7.3 Group reporting and disclosure

- In general, the industry notes that EIOPA has proposed deletion of a number of rarely used QRTs but other QRTs could also be deleted. However, in many cases the deletion of QRTs is not beneficial, since the data no longer being reported is still needed to create aggregated information for other QRTs. Further, it disagrees with the proposed changes to a large number of existing QRTs, which would be costly and not justified by the supervisory benefits. The industry made significant investment in defining and setting up the processes for data collection; these changes will cause additional costs, which will ultimately be borne by policyholders.
- The industry notes that EIOPA should wait for the conclusion of the 2020 review (including full scrutiny by the EU institutions) before making any changes to its QRTs and reporting requirements. The industry understands that EIOPA only needs Commission approval for ITS amendments, and Parliamentary / Council approval for RTS amendments. The industry does not believe EIOPA should act on any of its proposals before proper Level 1 and Level 2 strategic consideration of the issues.
- Paragraph 32: It is difficult to assess whether changes to solo templates apply on a *mutatis mutandis* principle. In section 7.3.4, para 7.32, it is mentioned that "*for the areas not specifically addressed within this document and applicable both at solo and group level the solo proposals shared during the first wave of consultation of SII Reporting and disclosure review 2020 apply as well at group level*". In para 7.35, it is mentioned that comments received and already included in the EIOPA Consultation on supervisory reporting and public disclosure are not repeated in this document. However, since EIOPA chose to split group reporting from solo reporting covered in the July consultation, it would have been important to get a complete picture of how the "*mutatis mutandis*" are expected to be applied between the solo reporting package and the group reporting or whether any adaptions are necessary.
- Paragraph 42: The industry **welcomes the proposal** to amend Art 254 of the Directive **to allow for exemption of group QRT reporting without the condition of exemption of all solo insurance undertakings belonging to that group**. EIOPA should ensure that a practicable procedure is defined in order to exempt the groups over the long term.
- Paragraph 48: EIOPA notes *"for the templates between S.01.01 and S.05.01 applicable at group level, the proposals published for solo are equally applicable at group level"*. Please refer to our wave 1 comments (incorporation of ECB add-on fields, alignment of IFRS 17 and Solvency II definitions regarding technical receivables and liabilities in S.02.01).
  - **S.01.02 – basic information**
    - Please refer to our wave 1 comments.
  - **S.02.01 – balance sheet**
    - Please refer to our wave 1 comments.
  - **S.02.02 – Assets and liabilities by currency**
    - Please refer to our wave 1 comments.
  - **S.03.01 – Off Balance Sheet items**
    - Please refer to our wave 1 comments.
  - **S.03.02/03 – 'Off-balance sheet items - List of unlimited guarantees received by the undertaking and Off-balance sheet items' – 'List of unlimited guarantees provided by the undertaking'**
    - The industry welcomes the deletion of both templates
  - **S.04.01 – Activity by country**
    - Please refer to our wave 1 comments.
  - **S.04.02 – Information on class 10 in Part A of Annex I of the Solvency II Directive, excluding carrier's liability**
    - Please refer to our wave 1 comments.

- Paragraph 53 (S.05.01 – Premiums, claims and expenses) – The industry welcomes the proposal to delete template S.05.01 at group level.
  - However, to provide relief regarding the reporting burden, S.05.02 should also be deleted, as both templates largely require the same kind of information.

- Further, for international groups, especially the shift from statutory GAAP on Solo-level to IFRS on group-level the reporting leads to confusion from the addressee's perspective. It seems unclear how in the group RSR/SFCR the information in the chapter on Business and performance should be reported without template S.05.01 which these figures are based on. According to annex 7.1 more detailed information is expected but without this template the information will be copied from financial statements only where there is no connection to Solvency II (e.g. no LOB structure). Clarification is needed.
- Template S.05.01 has implications for the Group SFCR and RSR requirements, which have not been fully considered here: DA Art 293(2) for the SFCR and DA Art 307(2)(a) and (c) for the RSR respectively stipulate the following: "*The solvency and financial condition report shall include qualitative and quantitative information on the insurance or reinsurance undertaking's underwriting performance, at an aggregate level and by material line of business and material geographical areas where it carries out business over the reporting period, together with a comparison of the information with that reported on the previous reporting period, as shown in the undertaking's financial statements*."
  "*The regular supervisory report shall include all of the following qualitative and quantitative information regarding the underwriting performance of the insurance or reinsurance undertaking, as shown in the undertaking's financial statements: a) information on the undertaking's underwriting income and expenses by material line of business and material geographical areas where it writes business during the reporting period, a comparison of the information with that reported on the previous reporting period and the reasons for any material changes. c) information on the undertaking's underwriting performance by line of business during the reporting period against projections, and significant factors affecting deviations from these projections*."
  EIOPA-BoS-15/109 2.4. states furthermore: "*When referring to section A.2 of the SFCR undertakings are expected to always refer to Solvency II lines of business, in line with the content of template S.05.01.as defined in ITS on the templates for the submission of information to the supervisory authorities."*
  In Germany, based on the latter the local regulator requires companies to report under A.2 of both the SFCR and RSR using the Solvency II lines of business. As a consequence, also Level 2 and 3 should be amended and state clearly that reporting under A.2 of the Group SFCR and RSR is not based on the Solvency II lines of business as respective data collection is not required at Group level. Instead, the lines of business used in the financial statements can be used.

- Paragraph 58: EIOPA proposes for Solo-entities to merge all QRTs containing cross-border information within one new QRT-format, while deleting the former ones. On Solo-level QRT S.05.02 will therefore be deleted from scope. It should be made sure that this QRT is not going to be required at group level. Some groups use collected S.05.02 QRTs reported by undertakings in scope of the group in order to prepare the group S.05.02 QRT. If the solo version is changed in the taxonomy, these groups will have to implement other reporting ways in order to obtain the necessary data.
- Paragraph 59: EIOPA notes that for template S.06.01 (summary of assets) the proposals published for solo are equally applicable at group level. In the first wave EIOPA proposed to delete template S.06.01 for solo. The industry welcomes this proposal to also remove template S.06.01 at group level.
- Paragraph 65 – 66 (S.06.02 – list of assets): EIOPA proposes to add various additional items to the list of assets template, without any corresponding reduction in the reporting burden elsewhere. While the current template is already extensive and onerous to produce, more information will be requested, and it is not clear for what purpose EIOPA/NSAs will use this information, or what justification exists for the additional reporting burden. It is also not clear what "complementary external financial information" EIOPA expects national supervisors to collect to balance this additional burden.
- Paragraph 68: EIOPA notes "*for the templates between S.06.02 and S.23.01 applicable at group level, the proposals published for solo are equally applicable at group level.*" The industry highlights that an overview of the proposals would have been useful in order to be able to easily and correctly assess these proposals. In any case, industry's concerns about the solo level additional reporting burden also prove to be applicable when transposed at group level. For example, for (re)insurers that have adopted an internal model to reflect their risk profile, introducing standard formula reporting requirements makes no sense at solo level as well

as at group level as capturing the economic reality of the group often requires more sophistication and flexibility.

- **S.06.03 - Collective investment undertakings - look-through approach**
  - Please refer to our wave 1 comments.
- **S.06.04 – introduction of new Look through template**
  - Please refer to our wave 1 comments.
- **S.07.01 – Structured products**
  - Please refer to our wave 1 comments.
- **S.08.01 – Open derivatives**
  - Please refer to our wave 1 comments.
- **S.08.02 – Derivatives transaction**
  - The industry welcomes EIOPA's proposal to remove this template
- **S.10.01 – Securities lending and repos**
  - Please refer to our wave 1 comments.
- **S.11.01 – Assets held as a collateral**
  - Please refer to our wave 1 comments.
- **S.15.01 – Securities lending and repos**
  - The industry welcomes EIOPA's proposal to remove this template
- **S.15.02 – Hedging of guarantees of variable annuities**
  - The industry welcomes EIOPA's proposal to remove this template

- Paragraph 72 (S.23.01 – own funds): The industry welcomes the proposal to keep template S.23.01 unchanged.
- Paragraph 78 (S.23.02 – detailed information by tiers on own funds): While the industry takes note of EIOPA's proposal to delete S.23.02.04.03 from template S.23.02 on 'excess of assets over liabilities – attribution of valuation differences', it notes that for a number of companies the proposed deletion will not reduce this burden and will cause issues for undertakings having to make IT systems changes – which will significantly add to costs.
- Paragraph 79: EIOPA notes "*for the templates between S.23.02 and S.32.01 applicable at group level, the proposals published for solo are equally applicable at group level.*" The industry highlights that an overview of the proposals would have been helpful in order to be able to easily and correctly assess these proposals.
  - **S.23.03 - Annual movements on own funds**
    - Please refer to our wave 1 comments.
  - **S.23.04 – List of items on own funds**
    - Please refer to our wave 1 comments.
  - **S.25.01 – Solvency Capital Requirement - for undertakings on Standard Formula**
    - Please refer to our wave 1 comments.
  - **S.25.02 – Solvency Capital Requirement - for undertakings using the standard formula and partial internal model**
    - Please refer to our wave 1 comments.
  - **S.25.03 – Solvency Capital Requirement - for undertakings on Full Internal Models**
    - Please refer to our wave 1 comments.
  - **S.26.01 – Solvency Capital Requirement - Market risk**
    - Please refer to our wave 1 comments.
  - **S.26.02 – Solvency Capital Requirement - Counterparty default risk**
    - Please refer to our wave 1 comments.
  - **S.26.03 – Solvency Capital Requirement - Life underwriting risk**
    - Please refer to our wave 1 comments.
  - **S.26.04 – Solvency Capital Requirement - Health underwriting risk**
    - Please refer to our wave 1 comments.
  - **S.26.05 – Solvency Capital Requirement - Non-Life underwriting risk**
    - Please refer to our wave 1 comments.

- **S.26.06 – Solvency Capital Requirement - Operational risk**
  - Please refer to our wave 1 comments.
- **S.26.07 – Solvency Capital Requirement – Simplifications**
  - Please refer to our wave 1 comments.
- **S.27.01 – Solvency Capital Requirement – Non-life and Health catastrophe risk**
  - Please refer to our wave 1 comments.
- **S.28.01 – Solvency Capital Requirement – Minimum Capital Requirement - Only life or only non-life insurance or reinsurance activity**
  - Please refer to our wave 1 comments.
- **S.28.02 – Solvency Capital Requirement – Minimum Capital Requirement - Both life and non-life insurance activity**
  - Please refer to our wave 1 comments.
- **S.29.01 to S.29.04 Variation analysis**
  - Please refer to our wave 1 comments.

- Paragraph 82 (S.23.04 – List of items on own funds): The industry welcomes the introduction of a risk-based threshold.
- Paragraph 95: the industry deems the changes to template S.32.01 not needed. Moving information from one template to another does not lead to any added value and implies high costs for undertakings to perform these changes. Furthermore, the industry **does not believe that undertakings should report the LEI Code for ultimate parent(s) and subsidiary(ies) for all undertakings**. This information is freely available in the LEI database for companies with financial service activity and supervisors can already look up these attributes. For companies not active on the financial markets this information is not necessary. Requesting and maintaining LEI codes for companies not currently requiring a LEI code will be a significant burden for groups with multiple undertakings that are not active on the financial markets.
- Paragraph 102: The industry takes note of the requirement to report the information regarding OF and SCR in case of the use of method one and to also report it for non-EEA undertakings. In paragraph 100 EIOPA notes that this information is also relevant for supervisors, but it fails to specify why.
- Paragraph 106 (S.34.01 – Insurance and reinsurance individual requirements): The industry agrees with EIOPA's proposal to keep the template unchanged.
- Paragraph 118 (S.37.01 – Risk concentration): The industry supports the proposals to simplify this template, namely to amend the template in line with the proposal under discussion in the context of the ESAs work on risk concentration reporting at the level of the FiCo.
- Paragraph 120: **The industry disagrees with EIOPA's proposal not to amend the Solvency II legislation regarding the addressees of the group SFCR**. This inconsistency would mean that the proposals for splitting the SFCR into two parts at solo level (policyholder and professional public) would be useless. The industry does not understand the logic behind EIOPA's decision, as also in the Single SFCR the split in two parts (policyholder and professional public) is reflected. Against this background, the industry suggests making the solo level proposals also applicable at group level.
- Paragraph 121: The **industry suggests making the solo level proposals also applicable at group level**, and to divide the Group SFCR into a section for the policyholder and a section for the professional public, consisting of a simple data extraction of the public QRT data without any set requirements for a narrative.
- Paragraph 137: External audit requirements were discussed and rejected during the development of Solvency II. While only leading to limited benefits, and clearly duplicating work in the remit of supervisors, the proposals would have significant additional burden and costs across the industry and would also not be workable within the timetable applicable to 2018 data. Against this background, **there should be no introduction of external audit requirements**. The possibility for NCA's to require additional auditing beyond the minimum requirement request (ie SCR and EOF) would be against harmonization in this regard. The external audit requirements would also be an issue in the context of equivalence, as it would force groups active in equivalent jurisdictions to produce information needed for an audit of group SFCR where locally there may not be such a requirement.

- Paragraph 138: The introduction of a minimum measure entails the risk that special national regulations will be introduced. It is therefore questionable why a Europe-wide regulation should be introduced at all.
- Paragraph 139: The industry is disappointed by the lack of clarity on the expectations towards the level of assurance of the audit required. This makes it difficult to have a clear/full overview of the proposals in the area of reporting and disclosure.
- Paragraph 143: The structure of the group (national or international) should be taken into account when determining the required languages of the RSR and SFCR.
- Paragraph 146: The industry **welcomes EIOPA's proposal to remove** DA Art 360 (3), and as such **no longer requiring the translation of the summary into the official language(s) of the Member State** where any of the (re)insurance subsidiaries of the participating (re)insurance undertaking, IHC or MFHC **has its head office.**
- Paragraph 151 - Templates used in the SFCR:
  - Generally, it is very hard to gain the full perspective of the changes EIOPA is proposing. EIOPA highlights its intention to keep the public disclosure templates unchanged. However, a lot of changes were proposed during the first wave. EIOPA should be clearer on the changes that are to be expected following its proposals on the supervisory reporting package (QRTs).
  - The industry believes that the QRTs and the public disclosure templates should continue to be closely aligned or the same, to ensure there is no duplication of effort.
- Paragraph 157 – Single (group) SFCR:
  - **The industry welcomes EIOPA's clarification regarding the single SFCR, possibly making it more attractive for insurers.** The splitting into a part for policyholders and a part for professionals also seems sensible here.
  - However, the industry would ask EIOPA to provide clarification on how its current proposals will impact firms who have approval to produce a single group SFCR, given that EIOPA indicates that the short policyholder section should not include group level information.
  - At the same time, the industry notes that EIOPA's proposed multiple deadlines for insurers to publish a single SFCR are impractical. This is meant to be a "single group SFCR", therefore, this "single" document should be subject to only one deadline. The consultation paper suggests that the deadline for production of the policyholder section of a single SFCR will be 16 weeks, whereas the deadline for production of the "professional" (other financial users') section will be 22 weeks. **To address this, the industry proposes that EIOPA establishes a single, 22-week deadline for production of a single SFCR**, thereby avoiding the practical difficulties associated with different deadlines for different parts of the same document.
  - In general, the proposal to keep, for annual reporting, the timetable applicable to 2018 data is welcomed, however this time is needed to fulfil the existing reporting requirements, independent of the external audit requirements EIOPA proposes.
- Paragraph 159 – The industry is **disappointed with EIOPA's advice not to allow a single group RSR**. The industry notes that a well-structured document can address the concern of the document being too lengthy. Moreover, it would be at the discretion of the parent company to produce a single group RSR, and as such the insurer is aware that the information is shared with several supervisors.
- In the first wave consultation, EIOPA mentioned on p 37 that it will discuss with its members "*the best way to promote a national/European repository*". In the current consultation paper, this proposal is not elaborated further. The industry highlights that before pursuing any of these ideas, EIOPA should further elaborate on its proposal, and it should consult with stakeholders. The industry would ask EIOPA to clarify when it will present its proposals in this area.

8. Proportionality (and thresholds)

The industry supports EIOPA's proposal on thresholds, eg the option for member states to raise the premium income threshold up to €25m.

The industry welcomes the Commission's ambition to improve the application of proportionality in Solvency II. Changes are necessary to ensure that any insurer can avoid, based on the scale, nature and complexity of its activities, unnecessary costs which ultimately would have to be borne by policyholders.

The industry supports EIOPA's efforts to improve proportionality, but its proposals are far from enough to ensure an effective and efficient application of proportionality. The following additional changes are needed to ensure that proportionality will work in practice and will be available as a potential tool for all companies:

- **The Directive must make clear that NSAs have a duty to always consider where they should allow companies to deviate from any specific requirements due to proportionality considerations, either by using approximations, simplified approaches or by not applying a requirement where appropriate.**
- **A "tool-box" needs to be created of non-exhaustive pre-defined simplifications (alternative calculation methods and/or exemptions from certain reporting templates) that can be automatically applied by companies when some predefined and risk-based criteria are met.**
- **In the context of the committee on proportionality created by the ESAs review, EIOPA should publish an annual report on proportionality. The report would evaluate the application of the proportionality principle per member state and make proposals on how to improve its effectiveness and consistency (similar to the EIOPA report on the use of limitations and exemptions from reporting).**

Furthermore, the industry notes that applying proportionality should not result in goldplating, and proportionality should not be mis-used to increase the burden for some insurers.

The following changes are needed to ensure that proportionality works in practice.

- The Directive must make clear that NSAs have a duty to always consider where they should allow companies to deviate from any specific requirements due to proportionality considerations.
- It must be possible for a simplified application of requirements, or even in some cases a non-application, where it is justified by the nature, scale and complexity of the insurer, ie where it has no significant impact on the evaluation of the solvency position or on policyholder protection.
    - For any risk with an impact <1% on the solvency position (or element of the balance sheet/total balance sheet), the undertaking or group can avoid all detailed reporting and insert zeros where needed, while keeping on monitoring the evolution of this risk as part of the risk management function.
    - For any risk with an impact <5% on total solvency (or element of the balance sheet/total balance sheet), the company can avoid detailed reporting and use estimation techniques to provide total figures where needed.
- A "tool-box" of non-exhaustive pre-defined simplifications that can automatically be applied by companies should be created:
    - Predefined simplifications should be allowed automatically when some predefined and risk-based criteria are met. Specific simplifications could include alternative calculation methods or exemptions from certain reporting templates.
- EIOPA should publish an annual report on proportionality including proposals on how to improve its effectiveness and consistency.
    - In the context of the committee on proportionality created by the ESAs review, the report would evaluate the application of the proportionality principle per Member State and make propositions on how to

improve its effectiveness and consistency (similar to the EIOPA report on the use of limitations and exemptions from reporting).

In addition, the industry notes that applying proportionality should not result in gold plating, and proportionality should not be mis-used to increase the burden for some insurers.

- As highlighted by EIOPA in its Guidelines on the valuation of technical provisions regarding possible simplifications, "*a closed list would not be in line with a principle-based approach to proportionality and might not provide proportionate calculation methods for all risk profiles, the simplified methods proposed in this paper are not to be interpreted as a closed list, but as possible methodologies to be applied*". This needs to be extended to all requirements across the three pillars of Solvency II. These provisions need to be included in the Directive and the delegated regulation, and not only at level 3, to ensure that NSAs feel legally obliged to duly consider the application of proportionality for all requirements.
- Proportionate supervision is key to ensure that Solvency II is effectively a risk-based framework:
  - Proportionality must apply to all insurance undertakings.
  - Proportionality could also mean choosing to not apply an individual requirement, on a case-by case basis.
  - Proportionality needs be applied across all three pillars.
  - Supervision should be obliged to promote proportional solutions.
  - The application of proportionality must be based on the nature, scale and complexity of risks, and not only on their size.
  - A "toolbox" should be introduced, which should include a <u>non-exhaustive</u> list of facilitations (see detailed examples in answer to Q8.1).
  - EIOPA should predefine risk-based criteria for an automatic application of some elements of the toolbox, without the possibility for NSAs to object.
  - Companies that do not meet these criteria would still be able to use the toolbox. However, they would have to document why an application is justified for them. This should not require a formal application, and the supervisor should have the possibility to object within a limited period of time.

Section 8.1 Thresholds for exclusion from Solvency II

- Paragraph 5: The industry strongly welcomes EIOPA's clarification on the concept and objectives of the principle of proportionality. Although Article 29 of the Directive highlights that proportionality applies "*in particular in relation to small insurance undertakings*", it is also important to note that all requirements must be "*applied in a manner which is proportionate to the nature, scale and complexity <u>of the risks</u> inherent in the business of an insurance or reinsurance undertaking*".
  - This means, as noted by EIOPA, that proportionality "*is to be applied where it would be disproportionate to the nature, scale and complexity of undertakings' risks inherent to the business to apply the requirements (both quantitative and qualitative) without relief*". This supports the industry's position in saying that when enforcing any requirement, NSAs must assess whether it is necessary, to achieve the goals of consumer protection and financial stability, to strictly apply the regulatory texts. These provisions in the regulation explicitly allow NSAs to deviate from the regulation where appropriate with regard to the risk profile of an undertaking, regardless of its size.
- Paragraph 6: The industry disagrees with EIOPA's view that proportionality should not result in "*an automatic exemption of parts of the market to all member States. This approach would not be risk-based and would not take into account the specificities of the undertakings or the markets*". Where some exemptions would be automatically applied to undertakings matching some predefined risk-based criteria, there would be no one-size-fits-all approach, and the risk profiles of companies would be taken into account.

  In fact, such automatic simplifications or reliefs are much needed in the insurance sector, as NSAs have shown reluctance to apply proportionality measures and to deviate from the legal text based on an assessment of the risk profile of undertakings. Although proportionality should ideally always be considered,

this is currently not the case and some automatic measures would provide a very much needed relief for many undertakings, without compromising the exercise of sound supervision.

- Paragraph 7: The industry notes that, in practice, the principle of proportionality is not effectively and efficiently applied with a risk-based approach across the Union.
- Paragraph 8: The industry supports EIOPA's argument that the implementation of a real risk-based supervision would allow NSAs to manage their resources in an effective and efficient way, and focus on the most relevant risks. This is also true for companies. A regulatory relief with regard to immaterial or more simple risks would allow undertakings to allocate more resources to monitor and manage key and more complex risks.
- Paragraph 9: The industry notes that proportionality should not be confused with a pure exclusion from the scope of the Directive. Exclusion is a different concept, based mainly on the size of undertakings that would be too small to consider an application of Solvency II (except for liability, credit and suretyship which are considered too risky to be exempted). Proportionality can apply to all companies regardless of their size, based on risks.
- Paragraph 32: The fundamental problem with EIOPA's approach to proportionality is that proportionality only works if and when the NSA takes the initiative to introduce proportionality measures and has a duty to ensure an effective application of proportionality.
- Paragraph 33: The industry supports EIOPA's advice to maintain the current methodology for the exclusion from the scope of Solvency II. However, the application of the principle of proportionality needs to be improved drastically. Solvency II is a very sophisticated framework that allows capturing most risks, but a one-size-fits-all application is not appropriate, and is not the framework regulators intended to build.
- Paragraph 34: The industry welcomes the proposals made by EIOPA in option 3. However, the minimum premium threshold should be €10m instead of €5m, in order to guarantee that very small undertakings are exempted, to avoid a conservative approach from NSAs, and to take into account inflation. In addition, the reinsurance premiums threshold should be adjusted accordingly to €1m premiums.
- Paragraph 39: The industry believes that the option to include a revision clause based on inflation should not be dismissed. Further options to take inflation into account while limiting volatility should be considered.
- Paragraph 44: The industry welcomes EIOPA's advice to raise the technical provisions thresholds to €50m. However, the premium income threshold should allow a Member State option between €10m and €25m (see comment on paragraph 34).
  Note: Paragraphs 8.46–57 are missing in the consultation paper.

Section 8.2 Proportionality in pillar 1

- Paragraph 3: The industry very much welcomes that EIOPA recognises the fact that proportionality must apply on all requirements, also where it is not explicitly mentioned in the regulation.
  The industry proposes that, in the future, the risk situation of a company should be assessed using defined criteria. On this basis, it will then be necessary to examine what simplification a company can make use of (eg alternative calculation methods and/or exemptions from certain reporting templates),which can be automatically applied by companies when some predefined and risk-based criteria are met.
  For example, the following criteria could be used for this purpose:
  - volatility of the SCR
  - volatility of the SCR/annual premium ratio
  - volatility of own funds
  - systemic relevance
  - coverage ratio
  Once the defined criteria have been reviewed and an assessment of the company has been made, a list of possible simplifications should be drawn up. Some examples are listed in answer to Q8.1.
- Paragraph 58: The industry welcomes that EIOPA is open to proposals to improve proportionality with respect to the calculations of the technical provisions.
- Paragraph 72: EIOPA's argument that it is not prudent to set a capital requirement to zero when the capital requirement is small or immaterial is based on the assumption that a risk has the capacity to grow in size.

However, in the case of non-life lapse risk, it is hard to see how the risk would grow, since this is essentially non-material for non-life business overall. In other cases, it would be possible to monitor the risk through the ORSA.

- Paragraph 74: The industry supports the view that the non-life lapse risk sub-module adds unnecessary complexity for a risk that is immaterial for non-life business. This should be removed from the standard formula, and not simplified for a limited number of entities for proportionality reasons. This would also solve the problem of double counting between the lapse risk module and the premium risk module.
  The Solvency II Directive does not foresee an additional capital charge for non-life lapse risk: Article 105 foresees that the non-life underwriting risk module consists of sub-modules relating to non-life premium and reserve risk and non-life catastrophe risk. It was only with the subsequent drafting of the Delegated Regulation that the non-life lapse risk sub-module was added. The reason for its inclusion has never been properly explained. The industry is not aware of any evidence that the lapsing of policies has ever created a material risk for non-life insurers, particularly in view of the 12-month period for which such policies are usually in force.
  The industry is of the view that for most non-life undertakings the non-life lapse risk sub-module contributes only an immaterial portion of the overall SCR and does not therefore contribute to the protection of policyholders or financial stability. This supports the simplification of its calculation, nothing that a better approach would be to remove the sub-module altogether.
- Paragraph 79: Proportionality should not be limited to a closed list mentioned in the regulation and proposed in this consultation. Additional simplifications/waivers need to be explicitly allowed. Besides providing additional (non-exhaustive) possible simplifications, the requirements for applying the simplifications in the standard SCR need to be less complex. Insurers should be able to apply their own simplifications, where justified by the risk profile, without significant burden of proof, with a limited period of time for NSAs to object.
- Paragraph 82: The possibility to group some lines of business might be a helpful simplification.
- Paragraph 85: The industry agrees that the application of outwards reinsurance in the context of non-life catastrophe risks can be very burdensome. However, it seems to be very conservative to determine the SCR in the nat cat module without considering reinsurance.
- Paragraph 100: Proportionality ensures that the application of the regulation is appropriate to the risk profile, and requires assessment and handling of own risks. The qualitative assessment should not require more effort than the release in burden that would be generated by the simplification itself.
- Paragraph 108: A mix of methods should be introduced (see also answer to Q8.2). Depending on the risk it might be more appropriate to use method 1 or 2. If the immaterial risk is assumed to develop similarly to the BSCR, it is advisable to apply method 1 in the application phase. If the risk does not correlate with the BSCR and is independent in its development, it might be better to derive the immaterial risk from using method 2. It should be left to the undertaking which of the methods is more appropriate to reflect the immaterial risk. Thus, both methods should be allowed.
- Paragraph 110: The industry welcomes EIOPA's intention to enhance proportionality in the calculation of the SCR. One of the main issues reported by the industry is that NSAs often do not feel legally able to deviate from legal texts, even though the Solvency II Directive explicitly states that NSAs shall apply this principle. In practice, it comes from the fact that, on some topics, the regulation, provides an exhaustive list of simplifications allowed. As a consequence, when some very much needed simplifications are not written, it is hard for NSAs to allow them. To avoid that, and to ensure that NSAs have both the ability and the responsibility to take into account the principle of proportionality when enforcing any requirement, Article 109 of the Directive "Simplifications in the standard formula" should be changed to:
  - *"Insurance and reinsurance undertakings may use a simplified calculation for a specific sub-module or risk module where the nature, scale and complexity of the risks they face justifies it and where it would be disproportionate to require all insurance and reinsurance undertakings to apply the standardised calculation.*

    ~~Simplified calculations shall be calibrated in accordance with~~ <u>A non-exhaustive list of simplifications allowed is provided in</u> Article 101(3). <u>Insurance and reinsurance undertakings may use other simplified calculations, provided these are duly justified</u>."

This would allow and encourage NSAs to develop further simplifications suited to the specificities of their market, and to also accept some simplifications proposed by companies where these do not have a significant impact on the solvency position. Thanks to the Committee on proportionality created by the ESAs review, NSAs will have a platform in which they can exchange views on the topic and share best practice, fostering convergence and ensuring that diverging approaches would only be a result of diverging market situations.

A change to Article 29 of the Directive is also needed, in order to make clear that NSAs have a responsibility in assessing to what extent a proportionate enforcement is needed for all requirements, when an undertaking wishes to apply proportionality:

- *"3. Member States shall ensure that the requirements laid down in this Directive are applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking.*
  When an insurance or reinsurance undertaking decides to fulfil a requirement in a proportionate manner based on its own assessment, national supervisory authorities have a duty to assess whether this proportionate approach is suitable according to the risk profile. Possible alternatives may include a simplification, a simplified approach or an exemption"

Moreover, the proposals by EIOPA are not mutually exclusive. Simplified calculations already exist in the Delegated Regulation. It makes sense to introduce new simplified calculations of capital requirements where appropriate. It is also appropriate to introduce an integrated simplified calculation for immaterial risks. Option 2 and 3 should be implemented.

Q8.1: In your view, are changes to the provisions on the calculation of technical provisions necessary in order to improve the proportionality of the requirements? Please make concrete proposals.

- Yes, proportionality needs to be improved, not only on all pillar 1 requirements, but across the three pillars.
- As noted by EIOPA, proportionality "*is to be applied where it would be disproportionate to the nature, scale and complexity of undertakings' risks inherent to the business to apply the requirements (both quantitative and qualitative) without relief*". This supports the industry's position that when enforcing any requirement, NSAs must assess whether it is necessary, to achieve the goals of consumer protection and financial stability, to strictly apply the regulatory texts. These provisions in the regulation allow NSAs to deviate from the regulation where appropriate with regard to the risk profile of an undertaking, regardless of its size.
- EIOPA highlights in its Guidelines on the valuation of technical provisions that it "*provides a non-exhaustive list of potential approaches for simplifications […] The proportionality assessment outlined in these guidelines is not only relevant for the selection of the methodologies for the calculation of technical provisions. Its resolutions should also be convenient to support other steps necessary for the calculation of technical provisions, such as data quality, segmentation, assumptions setting and validation. […] Given that a closed list would not be in line with a principle-based approach to proportionality and might not provide proportionate calculation methods for all risk profiles, the simplified methods proposed in this paper are not to be interpreted as a closed list, but as possible methodologies to be applied*". These provisions need to be included in the regulation, in order to ensure that NSAs effectively consider any simplified approaches developed by undertakings, in application of the proportionality principle.
  Conservative estimates on all immaterial SCR submodules as well as on immaterial balance sheet and reporting items should be made possible.
- To ensure that proportionality works in practice, specifically on Pillar 1, its application should be:
  - Possible in all areas of pillar 1
  - Based on pre-defined risk-based criteria
  - Company-specific and not focused on the size of the company or group (scale of risks is to be taken into consideration)
  - Possible on immaterial risks and components of the balance sheet for all companies regardless of the overall risk profile, without further evidence (conservative estimates or simple update of a former evaluation for items representing less than eg [5%] of own funds/capital requirements/BSCR)
- Moreover, a proportionate approach of a requirement only makes sense if the total effort required to apply it is noticeably lower than the application of the full requirement as laid down in the regulation. In addition,

simplified calculations should generally not be overly conservative in order to avoid unduly penalising their users.

In most cases, whether a specific proportionality measure is justified in relation to the risk and at the same time is effectively reducing the burden for the (re)insurer needs to be assessed on a case-by-case basis.

- The industry notes that the documentation of immaterial risks or balance sheet positions and qualitative requirements (eg validation of technical provisions or verification of the assumptions underlying the SCR) requires a disproportionate amount of work in relation to the size of the risk. Proportionality should also be applied to these qualitative requirements and not be restricted to simplifying approaches in the calculation of risks or balance sheet positions. This would be an efficient measure to really reduce the amount of work and the costs, as the documentation often requires even more time and effort than the actual calculation.
  Example from a large insurance company: there are some LoBs with only a few thousand Euros of premiums, claims, technical provisions and so on which is negligible compared to billions of Euros total business. In this case, the calculation of technical provisions can be done in a simplified way for proportionality reasons. However, qualitative requirements, for example related to validation (Article 264 Delegated Regulation) or to documentation (Article 265 Delegated Regulation) are the same as for the important LoBs. This is unreasonable and proportionality should also be applied here in order to reduce the amount of work for validation and documentation to a minimum for non-significant exposures. The same is true for all the other qualitative requirements on technical provisions and for all the qualitative requirements on SCR, etc. The time and resources that can be saved by reducing these requirements to a minimum for eg negligible risks or LoBs is better used in the calculation, validation and documentation of the significant LoBs or risks.
- Overall, regarding the calculations and their validation, the following concrete examples would also effectively reduce the unnecessary burden:
  - Quarterly calculations: allow a simplified update based on the annual calculation
  - Granularity of technical cash flows: allow greater aggregation
  - Models for valuation of life technical provisions (eg the "Branchensimulationsmodell" for German life insurance): allow by default that governance rules/written policies are updated only every [x] years if there is no significant change
  - Models for valuation of life technical provisions (eg the "Branchensimulationsmodell" for German life insurance): in general, allow for a standard calibration without individual justification for the Economic Scenario Generator (ESG)
- Specifically, the following possibilities are proposed regarding the calculation of own funds (non-exhaustive list):
  - Amounts recoverable from reinsurance: no adjustment for the expected default of the reinsurer. The corrections for the expected default generally are only a tiny proportion compared to the amounts recoverable.
  - Deferred Taxes: possibility to use the IFRS approach if IFRS is available
  - Deferred Taxes: for quarterly calculations in particular, simplifications should be explicitly allowed, since a tax balance sheet possibly may not be created quarterly (for technical provisions, simplified methods under EIOPA-BoS-14/166, Guideline 50 are also explicitly allowed during the year).
- Further, the following possibilities are proposed regarding the calculation of the SCR (non-exhaustive list):
  - Lapse risk (only for P&C and life, not health insurance): the best option should generally be to apply the shock factors to the total portfolio without a selective application. In the alternative, this should at least be provided as a simplification option.
  - Market risks: looking through the funds not at individual stock level, but based on overriding criteria (eg mainly Euro denominations, EEA issuers, average rating xy). If the above-mentioned criteria are met, the fund should be fully eligible for the corresponding category and not necessarily equity type 2, although no detailed look-through has been provided.
  - Spread risk: for interest rates with early termination possibility (callables), the spread risk must be determined on the basis of an expected termination date. Instead of an interest-rate-based valuation, a flat-rate regulation such as considering the next possible termination date would make sense.
  - Counterparty default risk: for the calculation of the default risk type 1, it is necessary for passive reinsurance to include among other things the risk-mitigating effect per reinsurer. To do so, it is first

necessary to determine the "normal" SCR for the underwriting risks, then for each reinsurer further "fictitious" SCR values based on the assumption that the contracts with this reinsurer do not exist. A simultaneous determination is not possible (repeated runs of the BSM required). Instead, the best would be to generally do without considering the risk-mitigating effect, as the counterparty default risk is only of secondary importance anyway. In the alternative, the consideration of the risk-mitigating effect should at least be possible through a flat-rate factor.
- Market risk concentrations: it should be possible to treat real estate funds without look-through as a single property (funds that do not account for more than 10% of the total investment are risk-free, as otherwise would apply to each property).
- Counterparty default risk: the use of a benchmark rating in the absence of a single stock or issuer rating should be allowed.
- Counterparty default risk: mortgage loans are subject to either spread or counterparty default risk, depending on criteria that are costly to review. Here, a simple assignment to the default risk is desirable.
- Risk mitigation techniques: simplified use of derivatives in each risk should be allowed.
- Loss-absorbing capacity of deferred taxes: specify flat-rate tax rate may be used without justification as an alternative to the individual rate determined from corporation tax and business tax.

- Generally, allowing a deviation from a specific calculation rule does not mean that the item does not have to be evaluated at all, but only that it can instead be determined in another way.
  In some cases, and/or at certain times, some calculations can be completely exempted. For example, the following waivers can be applied:
  - Additional verification calculations such as sensitivities, etc.
  - Quarterly fund look-through (instead an annual look-through review with a simple update during the year is sufficient)
  - Fund review for companies with very small volume of unit-linked investment.

Q8.2 What is your preference with regard to the options on introducing further simplifications to the calculation of the SCR standard formula?

- EIOPA highlights in its Guidelines on the valuation of technical provisions that it "*provides a non-exhaustive list of potential approaches for simplifications […] Given that a closed list would not be in line with a principle-based approach to proportionality and might not provide proportionate calculation methods for all risk profiles, the simplified methods proposed in this paper are not to be interpreted as a closed list, but as possible methodologies to be applied*".
  This approach should not be limited to the calculation of technical provisions, but extended to any requirement, including the calculation of the SCR (also see answer to Q8.1 for detailed examples). This would not undermine Solvency II concepts and policyholder protection, but would merely give room to calculate in a simpler way risks that are not significant. These provisions need to be included in the regulation, in order to ensure that NSAs effectively consider any simplified approaches developed by undertakings, in application of the proportionality principle.
- EIOPA's proposals are not mutually exclusive. Simplified calculations already exist in the Delegated Regulation. It makes sense to introduce new simplified calculations of capital requirements where appropriate. It is also appropriate to introduce an integrated simplified calculation for immaterial risks. Options 2 and 3 should be implemented.
- Apart from that, conservative estimates for immaterial SCR submodules as well as for immaterial balance sheet and reporting items should be allowed. Calculations in the standard formula include often more than 20 out of 40 submodules. Some of them are immaterial and make only a small contribution to the overall SCR. However, their accurate calculation ties up resources of risk management without contributing to policyholder protection. One first step to solving this problem is provided by EIOPA's recently published supervisory statement. This allows undertakings to re-use results of SCR calculations of immaterial submodules for up to three years.
- To simplify the current calculations, the Solvency II Directive should be adjusted. Article 109 requires that simplified calculations must be calibrated in accordance with Article 101(3), ie they must comply with the value-at-risk approach with a 99.5% confidence level. An adaptation of the Directive, which would allow,

among possible simplifications, conservative estimates of a potentially higher confidence level, would make sense. In addition, a similar approach would be useful for immaterial balance sheet and reporting items.

- Moreover, the industry highlights that in the current structure, it is the insurer who has to prove that the results of the simplified calculation do not materially diverge from the more complicated calculation. For smaller insurers that would mean hiring external advice for a potential conclusion from the consultant that the results do not materially diverge, and then a potential chance that the NSA agrees with that advice, and grants the insurer the simplified calculation. The risk of a negative outcome is too high for a less well-resourced insurer to even attempt this.
- Simplified calculations should therefore be a default for insurers who meet certain criteria of scale, complexity and nature of the risks. Insurers meeting the pre-defined criteria should benefit from simplifications by default, without a complex and lengthy process of authorisation. The NSA should bear the burden of proof that a more complicated calculation shows significantly higher outcomes. This should apply to all existing articles providing simplified approaches, and any further proposals on simplified calculations.
- All simplifications (including for example on counterparty default adjustment in Art. 61 of the Delegated Regulation) should not require permission in advance by the NSA and the NSA should bear the burden of proof that a more complicated calculation shows significantly higher outcomes.
- The default method for calculating the group SCR in art. 328(1)(d) of the Delegated Regulation should be the least burdensome method for insurers with a low risk profile.

Section 8.3 Proportionality in pillar 2

- Paragraph 118: The industry welcomes EIOPA's will to enhance proportionality in Pillar 2. Currently, even where proportionality can be applied, most undertakings concerned report complicated and lengthy processes to do so in practice.
- Paragraph 120: The industry welcomes EIOPA's statement that proportionality will be "*one of the main objectives of the review of the guidelines*". This should not be an argument to not provide an ambitious and workable enhancement of proportionality within the context of the 2020 review as a first necessary step, allowing for binding changes at level 1 and 2.
- Paragraph 121: The industry is of the view that providing "*common flexible criteria for the definition of 'small/less complex undertakings'* " at the level of guidelines is not sufficient in order to guarantee that the principle of proportionality will be enforced effectively. In order to have a solid legal ground, the Delegated Regulation should provide that these common flexible criteria will be defined via ITS/RTS.
- Paragraph 158: The industry welcomes EIOPA's advice to explicitly allow the combination of key functions with operational functions (except internal audit) on the basis of proportionality. However, although already broadly accepted by most NSAs, the current processes to apply this measure and the burden of proof are overly burdensome.
- Paragraph 159: The industry welcomes EIOPA's advice to explicitly allow the combination of roles of key function holder and member of the AMSB in the same person. Similar to comments on paragraph 158, although already broadly accepted by most NSAs, the current processes to apply this measure and the burden of proof are overly burdensome.
- Paragraph 160: The industry welcomes EIOPA's advice to explicitly allow the combination of key functions. Similar to comments on paragraphs 158 & 159, the current processes to apply this measure and the burden of proof are overly burdensome, although already broadly accepted by most NSAs.
- Paragraph 164: EIOPA's advice to not reduce the minimum content of the ORSA is a missed opportunity to enhance the principle of proportionality. In fact, some good practice is already observed, for instance with the "Low/Medium Low ORSA Template" provided by the Bank of Ireland. Further simplifications could be built on that model in order to accommodate undertakings with a very simple risk profile.
- Paragraph 165 & 176: The industry welcomes EIOPA's advice to request an assessment of the deviation from the assumptions underlying the SCR in the ORSA only every two years. However, proportionality could be further enhanced by allowing this assessment to be performed every three or five years when justified by the risk profile. Moreover, this would be in line with the timeframe proposed for the reassessment phase for the integrated simplification of SCR for immaterial risks, and with EIOPA's supervisory statement on the same topic.

  In addition, the EIOPA proposal does not include a simplified ORSA. On p. 146-147 of the impact assessment, EIOPA states that: "*option 2a.2 (standardised ORSA supervisory report for "small/less complex undertakings) is deemed to have a negative impact with respect to the objective of promoting good risk management and improving proportionality."* The industry notes that in the case of (re)insurers with a small scale, with a simple nature of business and a simple structure, a standardised ORSA would not interfere with good risk management, and this would be an appropriate application of the proportionality principle (see comment on paragraph 164).
- Paragraph 168 & 181: The industry welcomes EIOPA's advice to provide the possibility to review the written policies up to every three years instead of annually, when proportionality justifies it. However, in order to ensure an effective application of this option, it should be up to companies to set the periodicity of this review depending on their own assessment of their risk profile. NSAs could challenge this assessment without putting a significant burden of proof on undertakings. The frequency of three years should be an option by default, and a higher frequency should be justified by the risk profile. Not all written policies should be assigned a higher frequency, rather the approach should be tailored to the actual risks of an insurer.
- Paragraph 172 & 184: The industry welcomes EIOPA's proposal to limit the scope of the requirement to defer a substantial portion of the variable remuneration, to take into account the size of the undertaking and the portion of variable remuneration.

- Paragraph 174 & 175: The industry welcomes EIOPA’s proposal to explicitly allow some situations of combination of key functions. However, the combination of key functions should be allowed by default; NSAs should only have the power to object on a case-by-case basis. This would mean a redrafting of EIOPA’s proposed changes to the regulation, where condition (a) would be removed, and it would be provided that NSAs can object only where conditions (b) and (c) are not met, ie where it jeopardises sound governance and risk management.
  In addition, EIOPA should propose to allow undertakings to split the responsibilities of a key function between two persons. The EIOPA peer review on key functions observed a corresponding practice in some member states and didn't raise legal objections.
  The industry further suggests that a similar approach as suggested should be introduced in case of outsourcing of key functions, for consistency.
  Moreover, for all proportionality measures, it should be explicit that NSAs have a duty to consider whether proportionality should be applied in the application of all requirements. In that respect, all simplifications and measures allowed should be mentioned as non-exhaustive. In addition, it should be clear that undertakings can apply proportionality based on their own assessment, without a significant burden of proof. The creation of some automatic measures based on pre-defined risk-based criteria would be a good basis, as well as putting the responsibility on NSAs to challenge undertakings’ approaches (see comments on paragraphs 158, 159 & 160).
- Paragraph 180: There is no connection between proportionality and the inclusion of the written policy on remuneration in the Directive. The remuneration policy is already required under the Delegated Regulation.
- Paragraph 181: The less frequent review of written policies is a positive point but the wording “may be allowed” is confusing. A review every three to five years should be the norm, without prior approval of the NSA. Insurance undertakings should be competent to assess by themselves if, regarding their own risk profile, they need to perform a more frequent review.
- Paragraph 182: There does not seem to be any connection between proportionality and the requirement to review the composition of the AMSB for efficiency. This advice seems to be somehow misplaced. Furthermore, the Solvency II Directive does not contain any provisions on the composition of the AMSB. The criteria to review the composition are unclear, and national corporate laws differ on the composition of the AMSB.
- Paragraph 183: The ORSA process already requires an assessment of the governance system, board effectiveness as well as the regular reporting and disclosure cycle. It also implies that these elements are being assessed. Board effectiveness and the effectiveness of the system of governance are monitored on an ongoing basis within the organisation of any insurer, by the corporate bodies, the key functions, and to some extent the external auditor. It is not clear to us what value this additional requirement would add.
- Paragraph 184: The proposal for a threshold in Article 275.2 (c) of the Delegated Regulation (deferral of the variable component) is welcome, but it is also true that the threshold in the banking framework must be adapted to the characteristics of the insurance market. EIOPA makes a reference to its draft opinion that is not final and was highly criticised by the industry for its attempt to purely copy inappropriate requirements from the banking sector.

Section 8.4 Proportionality in pillar 3

- Paragraph 186: The industry fully supports EIOPA's intention to propose an increased proportionality of supervisory reporting and public disclosure. However, while its proposals across the two waves of the consultation on reporting include some potentially helpful concepts, the way these have been introduced and the significant additional reporting and many proposed changes to existing templates mean that EIOPA will not achieve its intentions but in fact increase the overall burden. Furthermore, no evidence is provided that this is justified by sufficient benefits.

  Moreover, currently Art. 35(6-8) of the Directive allows exemption from quarterly and semi-annual QRTs only on condition that the insurer has (a) good quality QRTs in the past and (b) a large and stable solvency position. An efficient application of proportionality would be to reverse the burden of proof, with a default exemption from quarterly and semi-annual QRTs, unless the insurer has (a) low quality QRTs in the past and (b) a low or unstable solvency position.

  The industry reiterates the need to implement a basic/additional set of QRTs in a way that would effectively enhance proportionality, where only the basic set would be required by default, with the NSA having the option to ask for additional QRTs where it is justified by the risk profile.
  Please refer to the joint industry response on the first wave of the reporting consultation.

9. Group supervision

The industry broadly disagrees with EIOPA's numerous (over 30 in total) proposals for changes in the area of group supervision.

Most of these measures aim at improving convergence of supervisory practices. While there may be a need for improvement, this should not be achieved by changes to the legislation, but more appropriately through the supervisory handbook, workshops, colleges of supervisors, etc. These tools also foster dialogue between NSAs, and between EIOPA and NSAs, and help foster better understanding as to why and how in some cases divergent practices are justified by the specificities of particular groups. This also avoids removing the existing flexibility in the regulation, much needed to ensure NSAs can adapt to the various structures and risk profiles of groups. In any case, where EIOPA chooses to arbitrate via any tool, <u>all measures must be prior subject to a detailed impact assessment</u>, as some proposals may entail a significant impact on the solvency position of groups or have other unintended consequences. Moreover, in view of the proposed amendments regarding group own funds and group solvency, it is crucial that the potential effects of these amendments are considered together with the effects of amendments at solo level.

The industry is in particular concerned by the <u>broadening of the scope of the minimum consolidated group SCR</u> to include insurance holding companies and mixed financial holding companies. As EIOPA proposes to leave the calculation of the minimum consolidated group SCR unchanged, this would increase the risk that it is breached before the group SCR (trigger inversion) and thereby would exacerbate the existing weaknesses of the minimum consolidated group SCR's design. The addition of <u>currency and concentration charges on undertakings aggregated with method 2 (D&A)</u> is equally concerning, as it appears to be adding prudence where several prudent buffers are already in place. This could easily lead to additional double counting of risks which EIOPA tries to avoid, and would have a substantial capital impact on groups.

Moreover, the proposals to consider <u>EPIFPs and benefits from transitional measures</u> on technical provisions and interest rate as unavailable by default at group level are inappropriate and do not reflect economic reality. These measures can have a material negative effect on group solvency and the group SCR while at the same time diminishing the risk sensitivity of Solvency II.
In addition, the proposed <u>additional powers for NSAs</u> to restructure a group, or to choose which company would be designated as responsible for horizontal groups are overly intrusive and too far-reaching compared to the (theoretical) benefits.

Further, there is no need for new clarifications on definitions and additional requirements where no specific issues were reported and the only justification is purely theoretical/hypothetical. Any change could result in costs and burden, and therefore changes should only be made when there is strong evidence that it is necessary and justified on a cost/benefit basis. When specific issues occur, they can already be solved by the NSAs and the supervisory colleges on an ad hoc basis.

As stated in the previous section, measures to increase <u>proportionality</u> are welcome also in the area of group supervision. NSAs must be allowed, encouraged and required to allow proportionality, where appropriate to the risks of the group, including where it leads to a deviation from detailed requirements mentioned in the regulation.

Section 9.3.1 Scope – Definition of the Group, including issues of dominant Influence; and Scope of the Group Supervision

- Paragraph 24: The industry does not understand why it is a policy issue that some entities are not considered to be a group pursuant to article 212. All the solo provisions apply to them, and NSAs can assess other elements in the context of supervisory dialogue. Specifically:
  - If companies have partly/fully the same shareholders: Own funds items have to meet the criteria as mentioned in the Directive and the Delegated Regulation. Whether the shareholders are the same will not have an impact on the solvency position of the insurer (unless ancillary capital is recognised and the counterparty is that same shareholder – in any case, this also has to be considered when assessing the admission of ancillary own funds).
  - Have AMSB/management body members in common: The relevant question is whether the AMSB/management body has enough time to act as AMSB and has sufficient independence. This is already part of the fit and proper assessment.
  - Have financial links: If the links are too dominant, a risk concentration will emerge which is already dealt with according to the current legislation.

  If there is no group for other purposes, such as accounting, EIOPA and NSAs should not try to create additional groups where it is not necessary. EIOPA does not highlight how this is related to policyholders' interest.
- Paragraph 27: EIOPA should highlight to what extent this poses a policy issue. It is unclear whether this problem is theoretical or has occurred.
- Paragraph 34: EIOPA should highlight to what extent this poses a policy issue. It is unclear whether this problem is theoretical or has occurred, ie in how many of the groups or possible groups this has effectively been identified as an issue. A principle-based framework shall be such that an individual supervisor can apply the appropriate supervision. The current legislation provides sufficient opportunities for an effective supervision of the solo undertakings, grouping of undertakings or groups.
- Paragraph 35: Article 212(1)(c)(ii) provides sufficient possibilities to include entities as part of a group.
- Paragraph 36: The term "centralised coordination" does not need to be further defined. NSAs have enough flexibility to assess it in the context of supervisory dialogue. Any additional "rules-based" definition risks to face cases where the definition is deemed to be ambiguous and may lead to different interpretations.
- Paragraph 37: EIOPA could assess the principles as laid down in the IFRS standards with respect to control or significant influence. An alignment would result in similar consolidation circles between accounting and Solvency II.
- Paragraph 39: EIOPA should highlight to what extent this poses a policy issue. It is unclear whether this problem is theoretical or has occurred.
- Paragraph 40: The industry deems it unjustified to give NSAs the power to require a legal restructuring of the groups. The current framework offers enough flexibility to exercise effective group supervision (see comment to paragraph 42).
- Paragraph 42: Article 212(1)(c)(ii) of the Solvency II Directive already allows NSAs to consider the existence of strong financial links (see comment on paragraph 46) NSAs can already exercise group supervision where a centralised coordination exists.

  While EIOPA proposes additional possibilities to require the creation of a holding company, it already foresees in its own analysis some issues that may arise: "*In cases where the group supervisor is not the supervisor of the designated entity (this could be happening if the designated entity is a holding company), both should cooperate to exercise supervision under it*". By trying to create a more formal framework to organise the group supervision at a newly created holding company, EIOPA risks to create new problematic situations of cooperation between NSAs, which is currently a weakness in the supervision of cross-border groups.

  The option is not proportionate to the scale of the issue mentioned. The creation of an EU holding entity would require many resources and create ambiguity as it would not reflect the real functioning of the group.
- Paragraph 45: If a look-through approach is applied to subsidiaries, all assets /liabilities are already included in the consolidated data.

- Paragraph 46: The industry disagrees with the proposal to amend Art. 212 of the Directive. Article 212(1)(c)(ii) already provides that a 'group' means a group of undertakings that is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings. EIOPA's attempt to clarify the regulation does not arise from identified issues, and the regulation already provides enough flexibility for NSAs to assess whether undertakings are managed on a unified basis.
  Definitions should be clear enough to allow undertakings in advance to assess the consequences of business decisions. Definitions should also be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive, as well as with banking and financial conglomerates regulations. Overall, there is no need for further clarification (also see comment to paragraph 24).
- Paragraph 47: Article 212(1)(c)(ii) of the Directive provides one of the definitions of a group. Article 212(2) provides the definition of a parent undertaking.
  Although definitions should be clear enough to allow undertakings in advance to assess the consequences of business decisions, definitions should also be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive. Overall, there is no need for further clarification.
- Paragraph 48: The regulatory framework provides flexibility for NSAs to qualify a centralised coordination. Legal forms of companies, holdings and cooperation among them differ among Member States. Providing a narrow definition, in an attempt to enhance convergence, could be detrimental to a necessary flexibility for NSAs, considering that the regulation cannot foresee all specific cases. "Centralised coordination" does not need to be further defined. NSAs have enough flexibility to assess it in the context of supervisory dialogue. Any additional "rules-based" definition risks facing cases where the definition is deemed to be ambiguous and may lead to different interpretations.
  Moreover, EIOPA does not quote any reported issue arising from this article justifying that a clarification should be provided. Changes relating to theoretical problems must be avoided, as they are likely to lead to incremental costs without clear benefits.
  The definition is clear enough to allow undertakings in advance to assess the consequences of business decisions. Definitions should also be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive. Overall, there is no need for further clarification.
- Paragraph 49: The industry disagrees with EIOPA's advice to provide NSAs the power to restructure groups. The pursued goal is unclear, as NSAs already have the power to consider as a group undertakings acting with a centralised coordination in Article 212 (see comments on paragraphs 46 & 48).
  The structuring of groups should remain a management decision. In general, NSAs should not be empowered to force groups to restructure themselves for the purpose of supervision. Only extreme situations could justify such significant interventions. In these cases, other legal frameworks such as corporate law must be taken into consideration by NSAs. The legal process must be applicable to the supervised undertakings, which is especially important for groups with undertakings in several jurisdictions.
  Providing NSAs the power to require a legal restructuring of the groups seems unjustified and not proportionate. The current framework has sufficient possibilities to be able to exercise effective (group) supervision.
- Paragraph 50: EIOPA's attempt to clarify definitions, where actually some flexibility may be valuable, is uncalled for. Changes relating to theoretical problems must be avoided, as they are likely to lead to incremental costs without clear benefits.
  Although definitions should be clear enough to allow undertakings in advance to assess the consequences of business decisions, definitions should also be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive. Overall, there is no need for further clarification.

Section 9.3.2 Scope – Definition of Insurance Holding Companies and other challenges related to Insurance holding companies and Mixed financial holding companies

- Paragraph 55: The current definition is used widely. EIOPA should clarify to what extent this poses a policy issue. It is unclear whether this problem is theoretical or has occurred.
- Paragraph 56: Article 214 of the Directive does not contradict Articles 218, 219 and 235. It provides exceptions in specific and defined cases. Articles 218 and 219 refer to the consolidated group data, which is subject to group supervision. There is no contradiction. In practice, the whole of the group will comply with the centrally set policies, risk appetite and governance, regardless of article 214 (1).
- Paragraph 62: The industry objects to EIOPA's proposal to define "exclusively" and "mainly" as more than 50% of the total of the balance sheet of holding defined as IHC. Such definition is inconsistent with other European regulations and IFRS 9. It is unclear how the proposal mentioned will solve the issue of the MAIHC, since this policy option only refers to IHC.
- Paragraph 66: It is unclear why all these measures are needed with regard to the policy issue mentioned in paragraph 60. The proposals do not seem proportionate to the nature and extent of the issue described.
- Paragraph 67: EIPOA's attempt to clarify the definition of an IHC, where actually some flexibility may be valuable, is uncalled for. Changes relating to theoretical problems must be avoided, as they are likely to lead to incremental costs without clear benefits.

  Although definitions should be clear enough to allow undertakings to assess in advance the consequences of business decisions, definitions should also be as consistent as possible with other European regulations, in this context for example with the definition of financial holding companies/mixed activities holding companies in the CRR.

  Moreover, it is unclear how the proposal mentioned will solve the issue of the MAIHC, since only reference is made towards IHC.
- Paragraph 69: The proposed powers are too far reaching, considering, for example, that these holding companies are not authorised entities and are not conducting insurance business. These powers are also disproportionate and contrary to the principle of independence of legal persons within a group. EIOPA considers very severe sanctions, while the holding insurance company may not be legally liable for decisions taken at solo level.

  Moreover, the measures at the disposal of NSAs should only be used in gradual stages. Significant interventions, such as suspending the exercise of voting rights, restricting distribution or interest payments to shareholders and reduce holdings in insurers or other financial sector entities, should only be allowed in extreme situations.

  The proposal to allow the transfer of participations is questionable from a legal perspective and could lead to unforeseeable consequences. Other legal framework conditions such as corporate law must be taken into consideration by NSAs. The legal process must be applicable to the supervised undertakings which is especially important for groups with undertakings in several jurisdictions. Corporate law does not seem to be taken into consideration in EIOPA's proposal (eg in most countries, if not all, the board only proposes dividends and does not vote the decision). Supervisory intervention in distributions to debt holders could have a significant impact on funding structure and should be very clearly drafted in legal requirements, as this can lead to contractual events of defaults towards investors, trigger acceleration of debt obligations and cross-default provisions.

  Further, a decision to temporarily designate another company within a group as responsible to ensure compliance should be left to the group itself, and not to the NSA. It is also unclear what would the designation of a temporary entity responsible for group requirements mean for the calculation of group Solvency.

  The proposed additional powers are not proportionate to the issues as described.

Section 9.3.3 Scope – Article 214(2) of the SII Directive - Exclusion from the scope of group supervision

- Paragraph 72: The exclusion from the scope of group supervision being at the discretion of the supervisor, the NSA should simply not grant this exemption if an exclusion would result in a problematic situation. Disagreements between NSAs or between NSAs and EIOPA should not result in changes to the regulation.

- Paragraph 78: It is unclear why this is an issue and what goes wrong in practice.
- Paragraph 89 & 90: Although the overall principle should be clear enough to allow undertakings to assess in advance the consequences of business decisions concerning the group formation, there is no need for further specifications. Supervisory flexibility is important to take into account differences in groups across the EEA.
- Paragraph 90: NSAs should not be required to consult EIOPA in the process of excluding an undertaking from group supervision. The ultimate responsibility belongs to the group supervisor, which can consult other concerned NSAs. In case of doubt or lack of resources/competences, NSAs can already ask for EIOPA's views anytime in practice.
- Paragraph 91: Although the definition of "negligible interest" should be clear enough to allow undertakings in advance to assess the consequences of business decisions concerning the group formation, the definition should be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive. However, in this case, there is no need for further specifications. It is important to allow for supervisory flexibility to account for differences in groups across the EU.

Section 9.3.4 Scope – Supervision of Intragroup Transactions (IGTs) and Risk Concentrations (RCs)

- Paragraph 97: The ESAs' consultation on technical standards on the reporting of intra-group transactions and risk concentration for financial conglomerates ended in August. Deviating from the requirements of FICOD and Solvency II Directive should be avoided.
- Paragraph 101: It is unclear whether EIOPA has in effect encountered the problem where the group supervisor was unable to retrieve the information as requested with respect to IGTs, and in how many cases a group deliberately excluded IGT information, considered by EIOPA as a "gap".
- Paragraph 104: The decision to replace Solvency II IGT with FICOD IGT should remain a decision amongst competent supervisors. There is no need to change the legislation to solve disagreements between supervisors. If appropriate, EIOPA could revise Chapter II of the guidelines on governance which deals with group governance aspects (guideline 69).
- Paragraph 108: Supervisory convergence should not be achieved by changes to the legislation. The setting of thresholds should be based on the risk profile and specific circumstances of any group concerned. If needed, guidance could be added in the guidelines rather than by amending legislation – which would most likely not even be able to cover all possible scenarios, group structures and characteristics.

  A QRT is only one tool in understanding the risk concentration. An insurer will more broadly embed concentration risk management and will describe this where relevant in the RSR/ORSA. The thresholds are set by the NSA based on the particularities of the Member State, the interconnectedness of risks and other characteristics. An EU-wide threshold would have many flaws as any threshold will be too high in one Member State and too low in another, whether relative or absolute. A too low threshold will see too many entries and a too high threshold, too few. This should be left at the discretion of NSAs.

  EIOPA does not highlight any cases where setting the thresholds wrongly induced bad supervisory practice, which in any case should be dealt with in the context of convergence of supervisory practices.
- Paragraph 118: Having different thresholds for different entities would be very burdensome to integrate in IT-systems and processes.
- Paragraphs 123 & 124: Reporting transactions between the MFHC or the MAIHC and any undertaking within the group, especially transactions that do not involve any insurance undertaking, could lead to an unduly burden and costs for larger groups without meaningful relevance from a prudential point of view. In consultation with the group supervisor, it should be possible to at least exclude defined transactions from the outset. For example, the joint administration of human resources for all undertakings in the group should be deemed important only in rare cases.
- Paragraph 125: The definitions and criteria for thresholds are sufficient. They are clear enough to allow undertakings to assess in advance the consequences of business decisions. Further, definitions should be as consistent as possible with other European regulations, in this context for example with the European Accounting Directive. In this case, there is no need for further specifications. Paragraph 125: The definitions and criteria for thresholds are sufficient. They are clear enough to allow undertakings to assess in advance the consequences of business decisions. Further, definitions should be as consistent as possible with other

European regulations, in this context for example with the European Accounting Directive. In this case, there is no need for further specifications.
EIOPA does not specify if the current setting of thresholds has in effect led to bad supervision.
For groups operating in both sectors, banking and insurance, and are financial conglomerates as well, reporting of IGT and RC can be a burdensome process. Supervisors should not require reporting under each framework.

Section 9.3.5 Third countries - Article 262 Solvency II Directive – Clarification

- Paragraphs 131 to 135: It is unclear whether this is a practical or just theoretical issue.
- Paragraphs 140: The 'clarification' proposed by EIOPA should not prevent supervisors from pursuing a proportionate approach, which may or may not involve the establishment of an EU holding company.
- Paragraph 147: Solvency II applies to any insurance company with a presence in the EEA or any insurance entity willing to sell insurance products to consumers in the EEA. Solvency II also provides requirements for insurers in equivalent and non-equivalent third countries within a group. Where equivalence is granted, the local rules may apply and be included in the solvency position of the group. However, if a third country is deemed to be non-equivalent, the group has to apply Solvency II to undertakings in that jurisdiction. For some risk modules, appropriate changes are included to accommodate the different non-EU situation (eg natural catastrophe risk). Some risk are calibrated at general market data (eg interest rate risk, spread risk, currency risk). However, for certain elements, the inclusion of non-equivalent third country subsidiaries in the group can result in onerous and inappropriate treatment.
  For example: Consider a non-equivalent third country with a credit quality step (CQS) below 3. An insurance entity in that third country has a reinsurance contract within the same third country. The local prudential legislation is applied and the insurer is deemed to be solvent based on the local legislation, but which is not deemed to be equivalent. Although there is no problem at solo level, it gets complicated once this entity is consolidated.
  When considering article 211(2)(c), an insurer located in the EEA must make sure that the risk mitigation is effective. According to this article, the reinsurance contract is not an effective risk mitigation since the CQS is below 3. If the non-equivalent third country insurer is aggregated as part of the group, the group has to apply all the Solvency II requirements to this subsidiary including article 211. Then, the risk mitigation, which is locally deemed to be effective and working, is not effective anymore. The impact on the economic balance sheet and the capital requirements is disproportionate.
  The impact is very negative, not intuitive, provides incorrect management incentives and has also a very negative impact on the willingness of groups investing outside the EEA in non-equivalent third countries and/or countries which have a temporary equivalence.

Section 9.3.6 Method 1 - Treatment of Insurance Holding Companies (IHC), Mixed Financial Holding Companies (MFHC)

Section 9.3.7 Method 1 - Article 229 of the Solvency II Directive – Proxy Methods

- Paragraph 184: The proposal to increase proportionality and introduce a simplified calculation for the purpose of group solvency calculation as an alternative to the use of Art. 229 of the Directive is welcome. However, the proposed simplification in paragraph 185 does not seem workable in practice (see comment to paragraph 185). In general, simplified calculations are welcome, provided that the regulation clearly states that the list of simplifications is non-exhaustive, and that their application does not result in a significant burden of proof, ultimately more burdensome than the calculation itself (please refer to comments on section 8).
- Paragraph 185: Although EIOPA's intention is to introduce a clear and simplified methodology for companies where the relevant Solvency II data is not available, the proposal would result in a more complex and unworkable calculation process.
  The adjusted equity method would have to be used for those companies where the relevant Solvency II valuation is not possible, with a cap on own funds. This implies valuing the participation (insurance company)

with its proportionate Solvency II excess of assets over liabilities, which is unworkable: for these companies the Solvency II data can be unavailable or too burdensome to collect with regard to proportionality considerations. Then, this requires calculating the respective SCR shock and finally consider the excess over the SCR value as unavailable, under the additional requirement that the simplification is approved by the NSA.
Under the current provisions of Art. 229 of the Directive, the application of the simplified calculation is not subject to approval by the group supervisor. It does not seem justified to require an additional approval. As highlighted in section 8, there should be no significant burden of proof and complex/lengthy process for a group to apply proportionality.
This proposal does not introduce a clear and simplified methodology.

Section 9.3.8 Method 2 - Scope of method 2 (where used exclusively or in combination with method 1)

- Paragraph 204: There is no need for further specifications. Article 328 of the Delegated Acts already provides for specific elements to be considered within the choice of the method. Additional regulation could result in undertakings having to change their calculation methods, while no specific issue was reported.

Section 9.3.9 Method 2 – Partial Internal Model (PIM) and Integration Techniques

Section 9.3.10 Group SCR calculation when using Combination of methods

- Paragraphs 261 & 262: EIOPA's proposals seem to indicate a view that groups using other methods than method 1 are avoiding capital requirements. The industry disagrees and considers method 2 or a combination of methods still to be an appropriate alternative for some groups (eg for mutuals with limitations on own funds' availability). Further, other measures than adjustments to Pillar 1 are a better way to address the issues identified and are already present (eg assessments in the group ORSA). In the opinion of the industry, a sufficient amount of prudence is already applied, through the use of D&A (no diversification) and prudent approaches (possible additional haircuts and factors > 1 on local sectoral SCR, such as in line with EIOPA's opinion of September 2015 on equivalence). Opening the door for additional SII risk views would introduce stacking of excessive prudence. The industry also strongly supports the application of Recital 125 of the Delegated Regulation, ie imposing SII views on top of (equivalent) local sectoral rules goes against the aim of ensuring level playing field in third countries.
  As such, the industry does not support introduction of currency risk charges and market risk concentration charges as proposed (see also response to Q9.2).

Q9.2: EIOPA invites all stakeholders to share their experience on the issues discussed above regarding the reflection of equity, currency and concentration risk in the group SCR under the combination of methods. In particular EIOPA is interested in input from the perspective of the standard formula and the perspective of internal models.

- The industry opposes calculating currency and concentration risk on participations in D&A insurers (see also comments on paragraphs 261 & 262), because there are already flaws in the group currency risk methodology. A number of conservative assumptions are already in place (eg no diversification benefit for D&A) and adding these requirements would add significant additional costs and burdens.
- The industry has highlighted for a number of years that the current group currency risk methodology over-estimates currency mismatches because it wrongly generates a capital charge when a company, very appropriately, holds assets in local currency to back a local currency solvency requirement (see Insurance Europe response to the EIOPA draft advice to the EC on the 2018 review of Solvency II and Insurance Europe Briefing note Currency risk March 2013). For a group with exposure to multiple currencies, the standard formula can give a poor representation of the currency risk. By forcing a group to hold capital against currency risk at the group level even though currency risk is perfectly well handled at the solo level, the design of the currency risk calculation will distort the incentives for good risk management practice at the group level. For a group with exposure to multiple currencies the standard formula can give a poor

representation of the currency risk. By forcing a group to hold capital against currency risk at the group level even though currency risk is perfectly well handled at the solo level, the design of the currency risk calculation will distort the incentives for good risk management practice at the group level.

- It should not be forgotten that the D&A method already comprises a conservatism buffer as it does not allow for diversification benefits. In addition, there is further conservatism through the stricter handling of "availability of own funds at group level" (Art. 330 DR) and even additional buffers for selected third-countries like the US where the actual local solvency requirement is increased by 300% as part of the D&A calculation. These buffers together with the existing Pillar II requirements for appropriate group risk management are adequate to cover potential unmodelled FX and concentration risk, ie the simplified approach is also justifiable.
- In this context, and further to the topic of double-counting the industry would like to highlight an additional source of unnecessary conservatism resulting from EIOPA opinion (EIOPA-BoS-16-008) and which also relates to the issues raised in paragraph 282 (D&A: entity by entity), paragraph 400 (minimum consolidated group SCR) and paragraph 442 (OFS and tiering). This opinion states that where a combination of methods 1 (AC) and 2 (D&A) is used, distinct tiering limits should be applied for each sub-group of the group, ie primarily (i) to the (re)insurance group subject to AC ("AC group", ie standard formula or internal model SCR), as well as (ii) to D&A (re-)insurers and (iii) to OFS entities. This industry is not aware of justification to this approach. The tiering limits on a group basis should be calculated for the entire group, ie the limit for tier 2/3 should be set against the total group requirement.
- The industry also notes that the level 1 text originally set the tiering limits against the own funds, and this was reduced in level 2 by setting the limit against the SCR. Furthermore, the tiering limits in the level 2 text are currently going beyond the quantitative limits set in the level 1 text, which seems inappropriate and unnecessary. This already limited significantly the levels of tier 2/3 allowed and is another reason why further restrictions are unnecessary.

Section 9.3.11 Group Solvency –Application when using combination of methods

- Paragraphs 271 & 272: The industry disagrees with EIOPA’s proposal to allow the application of method 2 only to legal entities one by one, and not to sub-groups. If, for example, the sub-group is managed on a unified basis but is not a subsidiary of the parent undertaking, diversification between the entities in the sub-group should be allowed, irrespective of whether the consolidation method can be used for the whole group.
- Paragraph 275: Double counting of risks, and omission of risks, is never acceptable. Also, when using method 2, it must not be required to include double counting in the capital requirement, eg by counting both a participation undertaking’s exposure to the equity of a participation and the risk in that participation’s assets and liabilities (see comment on paragraph 261).
- Paragraph 276: If there are issues with equivalence in third countries as regards rules on diversification, those issues should be addressed rather than introducing rules that can create unfair disadvantages to groups operating only within EU/EEA.
- Paragraph 282: There is no need for further clarification. If anything, it could be instead clarified that method 2 <u>can</u> be applied to sub-groups where a combination of methods has been allowed. The argument that this interpretation was published in EIOPA’s Q&As process is circular. This cannot justify disallowing the application of method 2 at sub-group level, while it has on purpose not been forbidden in the regulation.
- Paragraph 283: There is no need for further clarifications (see comment on paragraph 282).

Section 9.3.12 Own Funds Requirements for Groups

- Paragraph 296: EIOPA seems to indicate a potential issue, but it is unclear whether this has really happened in practice.
- Paragraphs 299 & 300: EIOPA does not indicate whether NSAs actually disregard Recital 127 of the Delegated Regulation, whether “*situation[s] where a NSA is challenged*” regarding the enforceability of the recital have occurred, or whether this relates to a theoretical issue.

- Paragraph 301: The industry does not understand where there is an ambiguity. Since the group has to comply with the solo requirements as laid down in the various legislative texts and the recital clarifies the solo treatment, this is also to be included in the group assessment.
- Paragraph 308: The industry is of the opinion that there is no need to add additional requirements. The sequence of requirements is clear. If supervisory convergence is the issue, this should be dealt with by means of convergence tools at the disposal of EIOPA rather than by changes to the legislation.
- Paragraph 311: The industry is of the view that the clarification is not needed. Normally, any winding-up situation exists when there is a breach of the SCR. In that case there is an automatic suspension of any payments. If 75% SCR is breached, debt instruments convert to the highest quality of capital.
  Documentation of subordinated debt is diverse, reflecting the specificities of each group's situation. For instance, conditions to redemption on the debt may often be conditioned to the parent's undertaking and/or the group breach of capital requirements and to the absence of any insolvent insurance affiliate winding-up, whereas the subordination clause may apply only to the claims of the issuing entity (parent company). But there will be some (implicit or explicit) commitment of the mother entity to cover losses where they arise in the group (sometimes it can also be materialised in formal parental guarantees which will subordinate the repayment to affiliates claims if the affiliate is unable to pay). It is not appropriate to provide for the repayment/redemption of an own find item when there is a winding-up situation of any EEA (re)insurance undertaking of the group. Existing practices are sufficient. In case of a small undertaking of the group, the group will be able to cover the losses and, in any case, this should not lead to stop the repayment of the debt of the group. If an entity is large, the stress will impact the parent entity and the group. It would also be difficult to justify that the change is limited only to EEA undertakings – but in any case, the enlargement of the subordination would create unnecessary complexities and be difficult or impossible to enforce in a cross-border context.

Q9.3: In light of option 2, stakeholders are invited to share their view on how this option contributes to a consistent policyholders' protection of related EEA (re)insurance undertakings regardless of the nature of the parent company of the group (group headed by a holding company vs group headed by an insurance or reinsurance company).

- The industry supports option 1 (no change, see comment on paragraphs 308 & 311).

Q9.4: In light of option 3, stakeholders are invited to provide their view on the potential challenges that groups may face to implement this principle.

- The industry supports option 1 (no change, see comment on paragraphs 308 & 311).

Section 9.3.13 Availability Assessment of Own Funds (groups)

- Paragraph 324: The group has to calculate the solvency ratio as being one economic entity. Based on this notion the economic balance sheet is determined. Subsequently the SCR is calculated based on this consolidated data. The next step is determining the available own funds and the eligible own funds. In this latest step, the availability and fungibility is assessed from all components of the own funds. Own funds of underlying entities deemed unavailable at group level are only taken into consideration up to the diversified contribution to the group SCR. This process still ensures no components are included which cannot be used to absorb losses elsewhere in the group. This process should be sufficient and no change is needed.
- Paragraph 325: The example provided is very farfetched. It is unclear in what sense EIOPA's proposal addresses a real and current issue within a group, and in how many cases an underlying entity has issued subordinated liabilities and has a low diversified SCR in order for the restricted own funds to be eligible for group purposes. In addition, the existing methodology to determine the solo contribution to group SCR and its coverage contains simplifications to a certain extent. Therefore, it contains approximations. However, potential weaknesses should not be addressed by new requirements upfront, as additional requirements would contradict the idea of a "simple" approach. Furthermore, if tiering at solo level has to be considered in the availability assessment, this would result in additional tiering restrictions, as the tiering at group level would build up on this tiering on solo level. Since the industry does not see a general issue, it would

recommend not to amend the existing requirements. If a weakness is identified in a very specific case, this should be discussed between the concerned group, undertakings and supervisors.

- Paragraph 330: Treatment of IGTs in the notional SCR and MCR is unclear. If it is not clearly stated that notional SCR and MCR should be net of IGTs, this would lead to multiple-counting of risks related to the same undertaking in the group calculations. In Q&A 383 regarding group supervision, and 387/388 regarding LACTP and LACDT, EIOPA has stated that IGTs are to be considered as part of the diversification effects. This results in an overestimation of the diversification effects and therefore too low amount of non-available own funds in the eligible own funds at group level. When including the notional SCR/MCR of a holding company, this will be increased significantly.

  The inclusion of a notional MCR for MFHC or IHC without adjusting for intragroup transactions would exaggerate the risks and could result in the minimum consolidated group SCR to be above the group SCR.

  The notional SCR/MCR of a MFHC or IHC is calculated based on the "company economic balance sheet". In this balance sheet the intragroup transactions are not eliminated. Subsidiaries are included based on their adjusted net equity value.

  Consider the following group: An IHC has as only as assets participations in the insurers A and B. Assume the following Solvency information:

	Own Funds	SCR	MCR	Ratio	MCR/SCR
Insurer A	150	100	35	150%	35%
Insurer B	250	200	90	125%	45%
Group	400	250	125	160%	50%

  The IHC has a total of own funds of 400. The minimum consolidated group SCR is based on the sum of the solo MCR. As there is no corridor at group level, the ratio MCR/SCR increases as the diversification benefits are only allowed at SCR level and not at MCR level.

  Consider the impact of the introduction of the notional MCR at the level of the IHC. EIOPA proposed as proxy 35% of the notional SCR.

  The notional SCR is based on the company balance sheet of the IHC. In this example, the IHC has only participations as assets. In the standard formula context, the capital requirement is then based on the equity risk module. Considering that the participations <u>do not meet the necessary criteria to be regarded as strategic</u>, the capital requirement is based on the 49% drop in equity prices. In this example, that would result in a notional SCR of 196. The resulting notional MCR is 68.6. The total minimum consolidated group SCR has become 193.6. The ratio MCR/SCR is now 77.4%, and the ladder of intervention is significantly reduced. The increase of the minimum consolidated group SCR is solely the result of a double counting because IGTs between the IHC and the rest of the group are not eliminated. If the own funds of the solo undertakings would be higher, there could be a situation in which the minimum consolidated group SCR becomes higher than the group SCR.

  If IHC/MFHC are included in the scope via a notional SCR/MCR, EIOPA should eliminate the IGTs from the calculations as is normally done for the calculations of the group SCR.

- Paragraphs 334 & 354: The transitional measures are designed to facilitate the transition to Solvency II. They reflect the different bases pre and post Solvency II on which the technical provisions and risk-free rates are determined. Transitional measures are intended to facilitate the transition at both solo and group level, therefore assuming by default that the benefit from transitional measures on technical provisions is not available at group level undermines their purpose.

- Paragraph 336: EPIFPs are the result of a valuation based on economic principles. They are fully recognised as unrestricted tier 1 items, and there is no justification for any changes.

  From an economic standpoint, the recognition of equity capital associated with future premiums on in-force business at group level is the natural consequence of their inclusion in the technical provisions and the build-up of an SCR to account for the associated risks. EPIFPs are an output of the economic valuation of the BEL (ie the present value of expected *future* cash flows) and the level of EPIFP depends on each undertaking's risk profile. Uncertainties relating to future cash-flows are modelled in the best estimate and thus reflected in the amount of EPIFP. The best estimate is calculated based on an exit value notion. This suggests that the insurance contracts are transferred to a willing third party. The transfer includes all rights and liabilities of the relationship between policyholder and insurer. The third party will also assume the future premiums

as part of the cash flows transferred. EPIFPs can be made available via several transactions (see comment on paragraph 356 and answer to Q9.6).
Moreover, unexpected events are already accounted for twice, in the risk margin and the SCR. There is no economic argument to go beyond the already high level of conservativeness included in Solvency II.

- Paragraph 337: The issue mentioned by EIOPA does not only exist for the assumption of EPIFPs, but also for all other elements when determining the best estimate of the insurance liabilities. The calculation of the risk margin is also based on the direct transfer to a reference undertaking. Furthermore, assuming EPIFP's non-availability at group level will treat EPIFP differently depending on its location rather than its economic value to the insurance group. A group no longer allowed to include EPIFP in group available own funds could be led to restructure to aggregate EPIFP in a single parent entity to make the capital available.
- Paragraph 347: EIOPA should ask NSAs how this is done in practice before stating this as an issue.
- Paragraph 351: Option 2 is seriously flawed and may mechanically imply a group insolvency situation, when in reality the group and its individual entities are all well-capitalised. If an IHC has no other asset than equities in an insurance company and has no liabilities the only source of risk and driver of changes to eligible own funds in the group is the risk profile of the insurance company. If that insurance company's assets-over-liabilities is 100% recognised as eligible own funds in the insurance company, but the local regulator has deemed some of the own funds to have limited fungibility and hence classified as a non-available item, the inclusion in the group eligible own funds is constrained to its contribution to the group SCR. With the proposed change, the situation with ICHs that do not add risk to the group is not considered and the insurance undertaking, which is the sole driver of volatility to eligible own funds in the group, sees its contribution to the group SCR being diluted. The contribution formula cannot be expanded as suggested, as it is too simplistic and cannot be used to determine inclusion or exclusion of non-available items in group eligible own funds without considering explicitly the group structure and the role of the IHC and MFHC, ie if they in reality add risk to the group SCR. The defection of the formula becomes elevated in a vertical "stacked" insurance group.
- Paragraph 354: Only the net effect of the benefits from transitional measures (value of benefit minus deferred taxes) is part of the reconciliation reserve. EIOPA did not consider that subtracting the gross effect of transitionals would lead to false results.
- Paragraph 356: The industry strongly disagrees that EPIFPs should be treated as non-available by default and be subject to transferability assessment. Art. 330 of the DR already provides for NSAs the power to challenge the availability of own funds items that are assumed available. Supervisors also have the power to review the best estimate calculations, knowing that EPIFPs are just an output of the economic value of insurance liabilities. The discussed availability assessment of EPIFP for group own funds is a very critical issue, and it is highly concerning that EIOPA is asking for the impact of considering the EPIFPs as non-available in the information request.
There is no economic reason for restricting solo excess capital (excess over contribution to group SCR) from the group available capital, as it would undermine the economic relevance of the group capital assessment. The issues which EIOPA is trying to address should already be addressed directly by the company under existing regulation on the risk management function, and by the supervisors using their existing powers (eg supervisory review process).
The EPIFP is available to absorb losses: if the asset suffers a loss in its own value it is as such directly absorbing this loss by itself. To cover operational losses (eg in the underwriting result) any asset must be sold or monetised to compensate for the loss in cash. Similarly, the EPIFP can be made available to generate cash and can be transferred across the group, through transactions such as sale of legal entities, portfolio transfer, merger of companies, reinsurance arrangement and securitisation. The timeframe for the completion of these transactions in six to nine months is realistic. There is no evidence that EPIFP should not be attributed to unrestricted Tier 1, including at group level.
The fact that EIOPA did not give a corresponding advice is welcome.
- Paragraph 357: EIOPA's advice not to introduce changes regarding the availability assessment under Article 330 (5) of the Delegated Regulation is welcome.
- Paragraph 358: Art. 222 Directive and Art. 330 DR are sufficiently clear regarding the scope of undertakings. In scope are any related insurance or reinsurance undertaking, third country insurance or reinsurance

undertaking, insurance holding company or mixed financial holding company. However, EIOPA should make sure that no separate SCR has to be determined for ancillary services undertakings. Further, it is important to note that the scope is restricted to related undertakings, and does not include the participating undertaking.

- Paragraph 359: The industry strongly disagrees with EIOPA's proposal to consider the benefits of transitional measures as unavailable by default at group level.
  First, to declare benefits from transitionals as unavailable would not be a "clarification", but a change in law. Second, the industry does not see any justification for such change in law (see also answer to question Q9.5).
  The transitional measures were introduced to allow undertakings to gradually adapt to Solvency II. Thereby, transitional measures were designed to be effective on the solo level as well as group level. The industry does not see any reason to change this implicitly by considering non-availability at group level and thereby differentiating the treatment of solo undertakings and groups. Excess own funds from using transitionals should not be treated differently to excess own funds from the difference in solo SCR and contribution to group SCR.
  EIOPA acknowledges that the latter is deemed available, yet no related undertaking could transfer these own funds to its participating undertaking knowing that a solo solvency breach would occur immediately. By contrast, transferring excess own funds from transitionals would not even necessarily cause a solo solvency breach, and in any case not directly.
  There should be no requirement to look through the reconciliation reserve and to do a separate availability assessment of its elements.

Q9.5: Taking into account that the availability assessment of own fund at group level is a complex issue, EIOPA would like to request feedback from stakeholders on which possible principle-based rules could be considered to reflect more appropriately the effective amount of available own funds at group level.
In particular, how could the minimum required quality of own funds, which solo insurers must comply with at all times, be reflected in the availability assessment at group level? (ie the question is not querying on the quality of the solo own funds at a given point in time, but how the availability assessment by the group supervisor can take into account the impact of a (potential) transfer of own funds within a group on the composition of solo own funds and on ongoing compliance with solo tiering limits – A*s an illustration, please refer to the case presented on the identification of the policy issue, paragraphs 9.325 to 9.327*).

- The industry disagrees with EIOPA's approach to the eligibility of own funds at group level.
- The availability assessment does not intend to assess the "the impact of a (potential) transfer of own funds within a group on the composition of solo own funds and on ongoing compliance with solo tiering limits". How would such a transfer be defined, for which entity and to which purpose? The Solvency II framework considers that solo own funds which can be made available at group level cover at the same time the requirements of the group – which is logical because a group consists of its solo entities. Solvency II considers that if an own fund item cannot be made available at group level, then it can only be available at the solo entity level, and therefore is limited at group level to the contribution of the entity to the group SCR. However, this principle describes the case where a group would only cover its SCR at 100%. Whereas losses at group level can arise from losses at solo level, the losses can be absorbed at solo level by own funds only available at the solo entity level. Thus, these own funds (unavailable at group level) also protect the group solvency from losses coming from the involved entity. Therefore, solo own funds items which cannot be made available at group level could be included in group own funds to cover losses raising from the specific entity.
- Principles-based rules already exist to reflect the effective amount of available own funds at group level and it is not surprising that most of the NSAs are very comfortable with the current approach.
- Moreover, a group has the option to default a legal entity. If this option is taken into account, the group must not hold more capital than group SCR = max_subs SCR_sub.
  However, Solvency II views groups as economic entities. The option to default is explicitly not taken into account. This is manifested eg via the requirement to calculate group SCR as diversified SCR of all entities belonging to the group (taking participation share into account). This reflects economic reality: most groups

are managed as economic entities and the option to default is not widely exercised as it undermines policy holder's trust in the whole group.

Therefore, any considerations of availability of own funds should be aligned to this economic reality and to the principles of Solvency II. This includes the possibility of sale of one subsidiary to support another subsidiary. The global and EU insurance industry experiences a significant number of mergers and acquisitions every year. Therefore, there is in practice a liquid market to transfer individual portfolios and whole companies from one ownership to another.

The Solvency II asset over liabilities (AoL) claim to provide for a market-consistent value of an undertaking. A franchise value is not taken into account. So, the Solvency II AoL should be considered a lower bound for a transfer value of an insurance undertaking. Consequently, there should be no transferability restriction on the AoL within an insurance group. Monetising via sale is possible.

These arguments apply even more to the EPIFP. Per definition, the EPIFP is a positive future cash flow and the likelihood of selling the corresponding portfolio is even higher than the likelihood of selling the whole company (and the sale of the whole company includes the sale of the EPIFP).

- The concept of availability is derived from Solvency I, where the group was not treated as an economic entity. Solvency II now treats the group as an economic entity, yet the concept of availability requires to reallocate the own funds of the entity "group" to the individual undertakings, while sticking to one (diversified) SCR of the entire group. This obviously causes larger conceptual issues and difficulties. The rationale is that a group must not show a high solvency ratio if all the capital is locked in one entity and can't be used to offset deficiencies which other entities have. Even if such rationale was justified, one would expect that the group solvency ratio would be at least as high as the lowest solvency ratio of any entity, even after deductions due to non-availability. However, no such floor exists, and the group solvency ratio may well be lower than the lowest solo solvency ratio. For example, where a large (re)insurance entity has a very high amount of non-available own funds, it contributes to the group own funds for an amount of own funds roughly identical to its diversified SCR contribution, even if it is very well capitalised. It is not convincing to require that own funds items be "legally transferrable". For example, a related undertaking can give a subordinated loan to a sister undertaking without reducing its own funds. Given these flaws and inconsistencies, extension or enhancement of the concept of availability should be avoided. A sound alternative approach could be to include discussions on possible transferability constraints in the supervisory dialogue between the group and the supervisor. In any case, when keeping the current regime, availability deductions be limited to minorities, surplus funds, deferred taxes and subordinated debt.

Q9.6: Which methods/tools would be possibly used to make own funds available within 9 months from one undertaking to another when large amounts of EPIFP exist?

- The industry strongly and fundamentally disagrees with EIOPA's view that EPIFPs should be assumed to be not available at group level by default. Art. 330 of the DR already provides for NSAs the power to challenge the availability of eligible own funds items. Supervisors are also granted power to review the best estimate calculations, knowing that EPIFP are just an output of the economic value of insurance liabilities. EIOPA's proposal would create legal uncertainty without bringing any new supervisory tool, while undermining the fundamental principle of the market-consistent balance sheet.
- The EPIFP is fully and unconditionally available to absorb losses: if the asset suffers a loss in its own value it is as such directly absorbing this loss by itself. Any asset must be sold or monetised to compensate for the loss in cash to cover operational losses (eg in the underwriting result). Similarly, the EPIFP can be made available to generate cash and can be transferred across the group, through transactions such as sale of legal entities, portfolio transfers, mergers of companies, reinsurance arrangement and securitisation. In the past some insurers already used these transactions to fund M&A activities. Securitisation of future in-force profits is a further method. The timeframe for the completion of these transactions in six to nine months is realistic. Of course, a sale of sub-portfolios that involves policyholder sharing is more complex, but the general argument persists. There is no evidence that EPIFP should not be attributed to unrestricted tier 1, including at group level.
- EPIFP should continue to be treated as an assumed available own fund item at group level since there are several methods to monetise EPIFP and make future profits available at group level, should the need arise.

Considering EPIFPs as non-available at group level would treat EPIFPs differently depending on their location rather than their economic value to the insurance. This could wrongly lead groups to restructure to ensure the availability of EPIFP (see comment on paragraph 337).

- As a matter of principle, it is reminded the amount of EPIFPs is linked to each undertaking's risk profile (ie there's no "good" or "bad" levels of EPIFPs per se). Changing the default assumption could distort existing business and lead to regulatory arbitrage.

Section 9.3.14 Minority Interest

- Paragraph 380: There are already specific guidelines on the treatment of minority interests.
- Paragraph 381: The industry agrees that the minority interest is also to be based on the economic perspective.

Q9.7: EIOPA invites all stakeholders to share their experience on the issues discussed above regarding the clarification of the definition of the item Minority interest in Solvency II and the approach to be followed for its calculation. In particular, EIOPA is interested in input from stakeholders to assess if the calculation of the minority interest should include of external subordinated debts.

- Solvency II is the decisive valuation method, and there is no reason to deviate from this for the determination of minorities. There would be no reason to consider external subordinated debt in the context of minorities as it is deemed unavailable anyway. This is line with EIOPA Guideline 14 on group solvency.
- It should also be noted that only direct minority interests are considered in the presented approach. Therefore, it should be kept in mind that sufficient flexibility must be maintained to ensure that the chosen approach is suitable for different legal structures.

Section 9.3.15 Minimum Consolidated Group SCR

- Paragraph 390: When considering any concerns about underestimation of the overall MCR, EIOPA should also recognised that there is no MCR corridor applied at group level and therefore already in many cases the a aggregate solo MCR/group SCR ratio higher than 45%.
- Paragraph 391: Similarly, if the notional MCR of ASUs and SPVs was to be taken into consideration, the inclusion of IGTs in the group calculation would overestimate the minimum consolidated group SCR significantly. It is welcome that EIOPA deems their inclusion in the scope as disproportionate.
- Paragraph 399: The industry disagrees with EIOPA's draft proposal. EIOPA itself recognises that this new proposal would require "*some effort*" and would only have a chance to "*partly solve*" the policy issue. In addition, the proposed MCR calculation ignores diversification and IGTs, is arbitrarily calibrated at 35% and applied to a notional SCR. Therefore, while the benefits are uncertain, the additional costs and the substantial increased risk of trigger inversion are certain.
  The industry is therefore very concerned that EIOPA both recommends to simultaneously (i) add holding companies to the calculation of the minimum consolidated group SCR (paragraph 399) and to (ii) leave the calculation of the minimum consolidated group SCR unchanged (paragraph 400). This substantially reduces the ladder of intervention and also increases the risk that the aggregate of the MCRs is higher than the group SCR due to multiple-counting of risks (trigger inversion). Overall, EIOPA's proposals on "notional SCR" and "notional MCR" are unclear and disproportionate especially as the IHC or MFCH do not bear (re)insurance risks. The notional SCR determined for IHC or MFHC can include a lot of IGT, especially with respect to the subsidiaries and so the subsequent group SCR can encompass duplications. By not addressing the issue of IGTs, the notional SCR/MCR can be largely overestimated.
- Paragraph 400: The current approach of the minimum consolidated group SCR is disproportionate for groups, negating most of the elementary diversification benefits. The introduction of IHC and MFHC would further enhance the flaws of the calculation and introduce several layers of double counting at group level.
  As a common example: an insurance entity held by another insurance entity that is held by an IHC is counted three times in the minimum consolidated group SCR. The first time when using local MCR plus corridor, the second in the local MCR plus corridor of the holder and finally in the 35%*SCR of the IHC. This is overly

prudent. The methodology should explicitly state that for minimum consolidated group SCR purposes, the local SCR to be used (in all the cases) should exclude intragroup participations. This is not the only source of IGTs that should not affect minimum consolidated group SCR (eg intragroup bonds and loans), but the most relevant and impactful in case of introduction of IHC and MFHCs.

Section 9.3.16 Inclusion of Other Financial Sectors (OFS)

- Paragraph 409: When extending group supervisory requirements in any way, there is a risk of legal inconsistencies across financial sectors. It is important that regulation regarding groups is consistent with the legal framework of financial conglomerates and with its equivalence in banking regulation. In this context, specific rules for the inclusion of OFS entities which deviate from sectoral requirements should be avoided.
- Paragraph 441: There is no need to change the legislation. It is clear that Art. 329 of the Delegated Regulation applies regardless of which method is used. EIOPA does not specify whether the issue mentioned has been observed in practice.
- Paragraph 442: OFS undertakings should be considered via sectoral rules. Solvency II regulations should not be forced onto the sectoral rules. It would be very burdensome to identify those own fund items, which have to be reallocated according to Solvency II tiering. At the same time, benefits would be very limited as it can be very misleading if some own fund items are reallocated while others are not.
- Paragraph 443: There are already flaws in the concept of availability (see answer to question Q9.5). Therefore, the industry proposes not to extend this concept to OFS entities. However, if an assessment of the transferability of own funds items from other financial sectors was to be introduced, harmonisation with other sectors would have to be ensured. An availability assessment of OFS own funds should only be necessary if the sectoral rules require such an assessment, where the OFS entity is subject to sectoral requirements that restrict transferability. In any case, a sound cooperation between the relevant supervisors of different financial sectors and a harmonised approach of criteria to assess the loss absorption capacity would be needed.
- Paragraph 444: EIOPA considers that the remaining part of the own funds items listed after coverage of the sectoral requirements should by default not be included in the group solvency. If such rules were to be used for inclusion of subordinated debt in banking sub-groups, the consolidated situation in that sub-group should be used and not the solo numbers (ie the result of an application of rules in the CRR on haircuts on AT1 and AT2 in the consolidated situation should be used if available). That would provide consistency between sector regulations.
- Paragraph 446: The industry understands that the interpretation in Q&A 1344 should apply to those entities under current prudential legislation. To the extent that legal entities are not subject to capital requirements on a stand-alone basis but should be included in the group solvency requirements using relevant sectoral requirements (which might be the case with some financial institutions and investment firms), a simpler capital requirement should be applied (without the need to calculate eg ICAAP capital, additional buffers).

Section 9.3.17 OFS – Application of Article 228 of the Solvency II Directive

- Paragraph 466: EIOPA's proposal to delete Article 228 of the Directive is highly concerning. Such a decision would require further in-depth analysis of the impacts.
  It should be borne in mind that a harmonised application, as proposed, could be an excessive reporting burden for the undertakings concerned. For example, a credit institution included in an insurance group may have to perform calculations that deviate from methods 1 or 2 of Solvency II according to other legal requirements. In consultation with the group supervisor, it should be possible to use this alternative method if the deviations from the results obtained with methods 1 or 2 are not significant.
  It is important to keep in mind that Art. 228 acknowledges financial conglomerate structures and regulations and any change needs to be assessed in that context. By deleting the article, FICOD groups would be required to calculate their group capital according to both the FICOD and Solvency II Directive, if the results of the calculations vary.

EIOPA has presented the issue in a very minimal manner. It is unclear whether the issue described has a real negative impact in practice, and what problems are observed in practice.
The industry notes that supervisory convergence issues should not be solved by legislation. Groups have their own specificities, therefore group supervision should be tailored to the unique characteristics. Whether all the criteria are satisfied is up to the dialogue between the group supervisor and the group.

Section 9.3.18 Governance – Application of Article 40 of the Solvency II Directive (definition of the AMSB for groups); and Mutatis Mutandis under Article 246 of Solvency II Directive

- Paragraph 469: In order to have an adequate system of governance in place, the AMSB is involved. Indirectly, article 40 of the Directive has to be complied with in order to be able to meet the requirements of articles 41 to 50 of the Directive.
  EIPOA does not provide any example in which the exclusion of article 40 of the Directive led to supervisory issues in practice (see comment on paragraph 501).
- Paragraph 483: The industry does not see any conflict of interest in cumulating key functions at ultimate parent level. Quite the contrary, there are no legal restrictions to the outsourcing of any key functions of any group entity to one person. This would not impede, but even contribute to a group wide system of governance.
- Paragraph 484: EIOPA implies that fit & proper requirements of the AMSB and key function holders at ultimate parent level must be based on a broader assessment with regard to their group responsibilities. Hence, the persons affected would be subject to solo and group assessments at the same time. The industry strongly disagrees with this assumption, one single assessment at group level is sufficient.
- Paragraph 499: It is on the one hand difficult to implement group guidelines on non-regulated entities and on the other hand there is no advantage and no need of doing so from a risk perspective. Most of the non-regulated entities only have supportive functions.
- Paragraph 500: The industry disagrees with EIOPA's advice to increase governance requirements at group level. Transposing solo requirements to groups may not cover all specific cases, while the current *mutatis mutandis* provision allows for enough flexibility.
  The group supervisor should not be granted power to designate a different company of the group or a specific company as responsible to implement a group-wide system of governance in the case of horizontal group (where the parent company is not clearly identifiable). This designation should remain the responsibility of the group – which is any case subject to the consent of the group supervisor.
  If the group supervisor was to be granted with this power, this should be limited to extremely rare cases and should explicitly be done in the context of supervisory dialogue, in cooperation with the group itself. The outcome should be to mutual consent.
- Paragraph 501: The industry disagrees with EIOPA's advice to increase governance requirements at group level. Transposing solo requirements to groups may not cover all specific cases, while the current *mutatis mutandis* provision allows for enough flexibility.
  The concept *mutatis mutandis* provides the necessary discretion to translate the requirements stemming from article 40 of the Directive in an appropriate manner to the group level. The group context is inherently different from the solo context so there is a need to allow adaptations to that context. In particular this is true for more detailed requirements included in the Delegated Regulation and EIOPA guidelines based on article 40, that are tailored to the insurance entity, not to a group.
  The industry sees no difficulties in setting up a group-wide governance under the current framework. The questions raised in paragraphs §476- to 494 do not require legislative interventions, but should be addressed in the course of ongoing supervision, granting supervisors and undertakings the flexibility to find suitable and proportionate solutions. If there are any issues in practice, the group supervisor should deal with the issue within the supervisory dialogue. Any solution can be tailor-made to the unique characteristics of the group and the risk profile of the group.

10. Freedom to provide services and freedom of establishment

The industry welcomes EIOPA's recommendations to <u>enhance the supervision</u> of insurance companies operating cross-border through the freedom to provide services (FOS) and the freedom of establishment (FOE), in order to prevent their failures and properly assess the fit and proper requirements.

In particular, the efforts to <u>strengthen cooperation between home and host NCAs</u> by increasing obligations for both and increasing home NCAs' responsibility in respect of their insurers' cross-border activities are welcome. The suggested means, which will give EIOPA the necessary tools to intervene where cooperation between NCAs is not sufficient (or where it fails) are also welcome. It is essential for the level of control to be the same across Members State, whether business is done in the home market or in another market via the FOS/FOE.

As a general observation, the industry notes that the new provisions on notification and cooperation platforms arising from the ESAs Review will apply to reinsurance as well as insurance undertakings, even though they will be inserted in a section of the Solvency II directive dealing with insurance undertakings only. Collaboration platforms could therefore be established for reinsurance undertakings carrying on business on an FoS/FoE basis and these would involve EIOPA.

Section 10.1 Extract from the call for advice

Section 10.2 Previous advice

Section 10.3 Relevant legal provisions

- Paragraph 6 – Articles 162-171 of the Solvency II Directive do not address the market access of **third country (re-)insurance undertakings which exclusively conduct reinsurance activities**. This leads to a fragmented and inconsistent regulatory landscape, as some Member States impose a local presence requirement on such undertakings while others do not. As a result, insurance and reinsurance undertakings are confronted with an unlevel playing field if they consider ceding (re-)insurance risks to undertakings located outside the EU on a cross-border basis. The market access of third country (re-)insurers which only operate reinsurance business should therefore be harmonized in accordance with international standards. Insurance Core Principle 13.4 of the International Association of Insurance Supervisors (IAIS) emphasizes the cross-border nature of reinsurance transactions and the market sophistication of the parties involved. This should be translated into a regulation which requires Member States to grant market access if the third country (re-)insurer is authorized to conduct reinsurance business in its jurisdiction and national competent authorities deem the supervision performed by and the cooperation with their third country counterparts as adequate. Such an approach would also be in line with the equivalence concept for third country reinsurers pursued by Article 172 of Solvency II as it applies to the treatment of reinsurance contracts for solvency purposes only. However, Article 172 of Solvency II should be adapted to Articles 227 and 260. These provide not only for an "equivalence decision" but also for the possibility of an "equivalence assessment" by the national supervisory authorities, which results in both being equal.

Section 10.4 Other regulatory background

Section 10.5 Identification of the issues

Section 10.6 Efficient information gathering during the authorisation process

- Paragraph 20 – The industry supports EIOPA's recommendation to require an undertaking applying for authorisation to disclose any refusal/withdrawal of *any* request for authorisation it may have submitted in another MS, and the reasons for it.
  This obligation should also include providing information on the fit and proper requirements for the claim representative appointed under article 21 of the Motor Insurance Directive (2009/103/EC) in cases where authorisation is sought to cover risks in class 10.

Section 10.7 Information exchange between home and host supervisors in case of material changes in the FoS activities

- Paragraph 29 – The industry supports the principle underpinning this recommendation, to enhance the information exchange between home and host NCA in cases of material changes in the FOS activities. However, the term "material change" should be clarified, including the criteria which would trigger this obligation on the undertaking's part, especially as art. 149 of Solvency II already requires any change in the nature of the risks or commitments to be subject to the notification procedure between home and host NCAs.

Section 10.8 Enhanced role for EIOPA in complex cross-border cases where NSAs fail to reach a common view in the cooperation platform

- Paragraph 38 – While the industry supports an enhanced role for EIOPA in complex cross-border cases where NSAs fail to reach a common view in the cooperation platform, the power given to EIOPA in this context should not result in a "name and shame" policy which could ultimately weaken an NCA's power in its jurisdiction, and therefore weaken supervision there instead of reinforcing it. It should also be noted that a similar proposal was already rejected in the trilogues for the ESAs Review in 2019. However, the pressuring power found in this proposal could be better framed by simply sharing the recommendation with the board of supervisors, which in itself already has a strong dissuasive effect and ensures other NCAs take note.

- Paragraph 39 – The industry is very supportive of the obligation for the home NCA to notify both EIOPA and the host NCA if an FOS/FOE undertaking's financial conditions is deteriorating or other risks emerge (including consumer protection concerns). Such proactive measures are very welcome.

Section 10.9 Cooperation between home and host NSAs during ongoing supervision

- Paragraph 46 – The industry sees the cooperation between home and host NSAs during ongoing supervision as an important factor for a healthy cross-border market. However, this should not deviate from the 'home Member State principle', which remains the rule even where there is significant cross-border business. In any event, the concept of "material cross-border insurance business" should be clarified, especially the threshold making a cross-border business "material".

Section 10.10 Explicit power of the host supervisor to request information in a timely manner

- Paragraph 56 – The suggested power for the host NCA to request information in a timely manner from the home NCA *and* the undertaking should be more strictly framed for the latter. There must not be information distortion between host and home NCAs, with the host NCA more up-to-date about an undertaking than its home NCA. The host NCA should only be authorised to approach the undertaking in exceptional cases, where the request for information addressed to the home NCA is urgent and was dismissed or not adequately complied with. An alternative mechanism could be considered in urgent cases, where shorter deadlines would apply, but the home principle should not be undermined in any way.

Section 10.11 Enhanced reporting requirements and exchange of information

- Paragraph 59 – The information exchange via the EIOPA hub could be improved for business lines other than life insurance.

11. Macroprudential policy

In light of the limited systemic risk that the insurance sector poses, and the comprehensive protection provided already by Solvency II, there is no justification for new measures that would result in significant initial and/or ongoing costs. The industry recognises that there is now an international framework for addressing systemic risk, and that the EC CfA reflects this framework to a large extent.

Therefore, only measures that have been specifically referenced in the European Commission's CfA (enhanced ORSA and PPP, LRMPs, SRMPs, pre-emptive recovery and resolution plans) should be considered and, if introduced, they should be implemented with strong proportionality provisions and only when the existing Solvency II framework can be shown to be insufficient to tackle identified material systemic risks and when it can be clearly demonstrated that the benefits of applying these new measures outweigh the costs.

There would be no justification to consider in Solvency II measures that go beyond the EC CfA and holistic framework for all the reasons mentioned above, but also because this would place Europe at a competitive disadvantage compared to other jurisdictions. Unfortunately, EIOPA has made a number of proposals which go beyond the EC CfA and the holistic framework, and the industry strongly opposes this. In particular, the industry strongly opposes awarding supervisory powers to apply new capital surcharges for systemic risk as well as any new intervention powers before the SCR is breached.

Section 11.1 Extract from the call for advice

<u>Comments on paragraphs of the consultation paper and on EIOPA's advice on macroprudential policy</u>

- Paragraph 2: In light of the limited systemic risk that the insurance sector poses, the industry strongly believes that only the tools mentioned by the European Commission in its Call for Advice (CfA) should be further considered in the context of the 2020 Solvency II review.
- Paragraph 3: The industry supports the current effective macroprudential framework that provides ongoing assurance that systemic risk remains limited in the European financial system and that ensures that if there are developments of real systemic concern these are identified and managed early. There is no justification for new measures that would result in significant initial and/or ongoing costs. The existing tools for the insurance industry already provide such a comprehensive macroprudential monitoring framework in Europe and so there is no evidence of a need for any further tools. This existing framework includes specific reporting requirements for financial stability, the EIOPA biannual financial stability reports and stress tests. In addition, the insurance supervisory system already includes many instruments with a macroprudential impact.

Section 11.2 Relevant legal provisions

Section 11.3 Identification of the issue

- Paragraph 7: The industry acknowledges that there are theoretically possible systemic risks emerging from the insurance sector, but would also point out that, so far, the existence of systemic risk in insurance has not been adequately substantiated. The one example often quoted regarding such a risk is in fact an example of systemic risk stemming from non-insurance activities. Before additional macroprudential measures can be shown to be useful and appropriate, the nature of systemic risk and its materiality in insurance needs to be more clearly evidenced and articulated. In practice, potential systemic risks are of limited relevance for insurance, given the nature of the insurance business model, actual activities of European insurers and limited transmission channels, but also the already existing supervisory framework.

- Paragraph 11: The industry disagrees with EIOPA's statement that currently there is a lack of macroprudential policy in the insurance industry. In the aftermath of the global financial crisis of 2008, reinforced by the negative impact of the low interest rate environment, macroprudential policy has been greatly extended, encompassing the insurance industry as well. Examples are EIOPA's risk dashboards and financial stability reports, stress tests, the design of Solvency II (e.g. the inclusion of macroprudential elements, transitionals) and additional national macroprudential supervision.
- Paragraph 15: EIOPA links the direct and indirect impact of macroprudential policies. Figure 11.1 highlights from the perspective of EIOPA how insurers could create or amplify systemic risk. When considering this figure, one has to consider that individual insurers under Solvency II have to maintain capital to absorb a loss of a 1-200-year event. Based on article 45 of the Solvency II Directive, insurers also have to assess those scenarios which could have an adverse effect on the capital position in the long run. In table 11.1 and annex 11.1, EIOPA lists several kinds of macroprudential events. However, these should actually already be covered by insurers complying with the existing Solvency II requirements.
- Paragraph 17: With respect to the table in Annex 11.1 and Table 11.1, the industry would point out that:
  - *Entity-based related sources*: It is unclear from the table and the description how these entity-based sources relate to the ladder of intervention before a failure really occurs.
  - A*ctivity-based related sources*: EIOPA identifies non-hedging derivatives as activity-based source. However, it is not clear how this would relate to systemic risk creation. Besides, investments and products sold are subject to internal policies of management, risk tolerances and risk limits. In this sense, the supervisory authorities would question any exaggeration or breach as part of the supervisory review process already in place.
  - B*ehaviour related sources*: The sources mentioned would only exist if insurers would fail internal processes or have inappropriate risk appetite, tolerances and limits. This is exactly where the Solvency II framework already has supported insurers in further improving and developing their risk framework.
- Box 11.2: The traditional insurance business has proven extremely resilient to business cycle fluctuations in the past, as evidenced by the fact that insurers weathered the global financial crisis of 2008 quite well. Very limited government support was necessary, as EIOPA notes. Even before Solvency II, there were very few failures and even fewer resulting in any losses for policyholders. Insurers have rarely needed to benefit from government support, and under Solvency II they will be far less likely to do so in the future (no Solvency II compliant insurer required public assistance to date).
    - The example of AIG is entirely irrelevant for the current European discussion on macroprudential policy, given the extremely risky non-insurance activities that lead to the company’s downfall during the financial crisis. Running such a business model would not be possible under Solvency II and there is no evidence that any insurance group currently owns non-insurance entities that engage in comparable activities.
    - The IMF models for systemic risk based on the tsunami and domino scenarios are high-level theoretical concepts and not based on real underlying evidence of systemic risk.
    - Any potential search for yield behaviour in the low rates environment is already addressed in the existing Solvency II regime e.g. by highly conservative asset risk capital charges.
    - It is rather surprising that EIOPA does not emphasize the role of (re)insurers as counter-cyclical investors, a feature that is widely recognized by e.g. Committee on the Global Financial System (CGFS) of the BIS.

- Paragraph 21: In addition to the comments under Paragraph 17, the industry would point out that:
  - Some tools in Solvency II are useful in preventing collective behaviour that may exacerbate market price movements. The volatility/matching/symmetric equity adjustments were designed to reflect the long-term nature of insurance and/or the economic impact of asset liability management. As such, they are meant to help avoid excessive transmission of market volatility to insurers’ balance sheets and therefore reduce the risk that Solvency II measurement encourages, otherwise unnecessary, procyclical behaviour during stressed events.

  - One of the “operational objectives” targeted is “to discourage risky behaviour”. What is the definition and who will define this? Risky behaviour would in general, under Solvency II, lead to higher capital requirements. High concentrations will also lead to additional capital requirements.
- Paragraph 26: because the analysis of existing measures in the second of EIOPA’s papers only focuses on aspects of Solvency II that EIOPA considers as having macroprudential relevance, it fails to adequately consider Solvency II as a whole. By limiting its focus in this way, EIOPA fails to address elements of Solvency II that may have systemic relevance, such as the risk margin. EIOPA should analyse how certain provisions of Solvency II could damage the stability and effectiveness of the financial system in supporting the EU economy (eg, artificial volatility, incentives for pro-cyclical behaviour, disincentives for long-term investment). EIOPA should fully consider not only how existing Solvency II measures mitigate systemic concerns and how any additional tools link to them, but also the existing roles/activities that it and the European Systemic Risk Board (ESRB) have in relation to systemic risk, in order to determine whether there are any deficiencies that would warrant additional measures. EIOPA’s analysis should cover, eg, the role of EIOPA’s stress testing, its preparation of market wide risk indicators, and its regular financial stability reports and risk dashboards.
- Paragraph 32: The industry disagrees with the proposal to introduce new macroprudential tools and measures in a general article on macroprudential supervision. As far as additional macroprudential provisions are necessary at all, they would, as a matter of principle, be better placed as an enhancement of existing provisions. In the industry’s view, there is often no clear delimitation between micro- and macroprudential tools and interventions.
- Paragraph 37: The industry recognises that there is now an international framework for addressing systemic risk and European insurance supervision should be in line with the principles of this new framework. The EC CfA reflects this framework to a large extent. There would be no justification to consider in Solvency II measures that go beyond the CfA and the Holistic Framework on the specific measures that may be included, because this would place Europe at a competitive disadvantage compared to other jurisdictions. Unfortunately, EIOPA has made a number of proposals which go beyond the EC CfA and the holistic framework, and the industry strongly opposes this.

Section 11.4 Analysis

11.4.1 Capital surcharge for systemic risk

- Paragraph 46: **Capital surcharge for systemic risk – the industry strongly opposes the introduction of supervisory powers to impose capital surcharges for systemic risk.**
- Paragraph 52: the table shows that a main source of systemic risk is a deterioration of the solvency position, leading to failure of a SIFI or collective failures of non-SIFIs as a result of common activities or exposures. Solvency II is a risk-based capital regime and already contains a supervisory ladder of intervention to address the deterioration of a firm’s capital position. Given this, it is unclear how EIOPA considers that imposing additional capital would help.
- Paragraph 53: Capital cannot be the default response to systemic risk. Instead, where real systemic risk exists, other mechanisms, such as ensuring supervisory oversight and good internal controls and risk management, are essential and effective. Given the comprehensive nature of Solvency II, risks which could lead to systemic concerns (such as losses in asset portfolios or mass customer policy surrenders), are already covered. Therefore, it is unclear why there would be need for additional capital and in fact, such additional capital surcharges are more likely to aggravate issues than address them.
- Paragraph 56: EIOPA has not demonstrated how a capital surcharge could help mitigate systemic risk. The focus on deterioration of solvency positions is already adequately addressed through the prudence of Solvency II and the ladder of supervisory intervention. EIOPA should clearly explain in which circumstances it believes a requirement to hold additional capital would be effective in mitigating systemic risk and how its proposal would be more effective than Solvency II requirements that already exist, including the existing ability to require a capital add-on where risk is not adequately reflected.

11.4.2 Concentration thresholds

- Paragraph 63: As EIOPA notes, the current Solvency II framework has a number of tools already in place to address this risk at a microprudential level, such as the prudent person principle (PPP), own risk and solvency assessment (ORSA), asset concentration risk charge. These tools were designed to address the risk of excessive concentrations and to encourage appropriate risk management and appropriate diversification.
- Paragraph 78: As soft concentration thresholds for supervisory purposes, by their nature, would not be binding, there is no rationale for amending Solvency II. The industry does not believe that supervisors are currently constrained by Solvency II in adopting "soft" thresholds as part of their supervisory process should they choose to do so. While it may be interesting and valid from a systemic risk standpoint to monitor the level of various investment exposures, **the industry does not agree that the calibration of "soft" thresholds at company level could contribute significantly to the mitigation of systemic risk**. It is therefore difficult to see this as a macroprudential tool. Similarly, sector-wide soft thresholds would be unlikely to be helpful given the varied nature of insurers' business models, resulting in unpredictable implications if any supervisory decisions were based on it.
- Paragraph 79: As EIOPA states as well, there are significant operational challenges in applying this tool. In view of this, it is questionable how effective this instrument would be in further reducing concentration risks. At the same time, costs and negative side-effects could be substantially higher than stated in EIOPA's analysis. Concentration thresholds or exposure limits go against one of the key intentions in the transition from Solvency I to Solvency II. Rather than applying allocation limits, insurers can decide over their strategic and tactical asset allocations within limits of own funds available. Even "soft" supervisory concentration thresholds could lead to a distortion of the necessary balance between profitability, liquidity and security at the portfolio level of the individual insurer. They would restrict insurers in their choice of investments and could lead to herd behaviour and pro-cyclical actions rather than mitigating them. Besides, assets are managed in the framework of the undertaking-specific ALM to ensure a match with the liability side. "Soft" thresholds could also force insurers to dispose of certain assets in anticipation of reaching the limits. At financial market level, selling pressure or forced sales would have negative side-effects and could be potentially destabilising. De facto, "soft" thresholds could also result in strict requirements; thus, any form of thresholds should be avoided, especially in a sophisticated risk-based framework such as Solvency II.

11.4.3 Expand the use of the ORSA to include the macroprudential perspective

- Paragraph 84: Insurers are already required to consider in ORSA all material risks that may have an impact on their ability to meet their obligations to policyholders. Hence, insurance companies are already considering systemic risks that could have a material impact on their business, eg credit cycles, real estate bubbles, reduced market liquidity.
- Paragraph 86: Given the above, **the industry would caution against greater prescriptiveness in the ORSA process, as the liberty to choose relevant scenarios is a key component to the ORSA's value. Any further clarification should be proportionate and principle-based. "Enhancing" the ORSA as EIOPA suggests would actually increase its complexity and diminish its usefulness to insurers and its wider financial stability benefits.** In addition, ORSAs are already assessed by the relevant supervisory authorities and the industry does not agree that the addition of another layer of macroprudential supervisory approval is warranted, justified or desirable.
- Paragraph 88: EIOPA discusses extending the current scope of the ORSA process to include a specific macroprudential aspect in order to check the ORSA reports against macroprudential risks. To this end, it envisages that macroprudential authorities will aggregate input from individual company ORSAs, analyse this information and then provide macroprudential input to supervisors which can be used as part of the ORSA process. The industry questions whether the potential benefit of analysing the process and organisation of many thousands of ORSAs would justify the cost of such a process. It seems impossible to collect ORSA data and to ensure comparability, due to the fact that the ORSA is the company's own analysis. This means that insurers' ORSAs differ greatly in terms of, for example, focus, content and design. And to require insurers to follow certain templates for the ORSA (in order to facilitate data collection by EIOPA) goes strongly against the purpose of the ORSA. It is therefore questionable whether such an exercise would be useful in decision

making, or would provide additional insights above those obtained from current EU stress testing exercises. Indeed, there are significant, if not identical, overlaps to what the EU stress testing exercises aim to establish and the suggested additions in the ORSA.

- Paragraph 95: The industry believes that **a more proportionate and pragmatic approach would be for NSAs to continue to assess the ORSA on a standalone basis and to discuss any macroprudential concerns with the relevant macroprudential authorities, such as the ESRB.**

11.4.4 Expand the prudent person principle to take into account macroprudential concerns

- Paragraph 101: Investment strategies are based on ALM studies. The characteristics of the insurance liabilities, the risk appetite and additional risk limits are key in setting any investment strategy. Any interventions of the supervisory authorities in this process will have a negative impact on the ability to align the cash flows and/or returns necessary to meet the obligations towards the policyholders.
- Paragraph 104: EIOPA states that one of the objectives of the **enhanced PPP** is to avoid "excessive concentrations". In Article 260 on Risk Management Areas of the Solvency II Delegated Regulation, the following is stated: *"(e) Concentration risk management: actions to be taken by the insurance or reinsurance undertaking to identify relevant sources of concentration risk to ensure that risk concentrations remain within established limits and actions to analyse possible risks of contagion between concentrated exposures."* Before any additional tools are introduced, EIOPA should assess how this existing requirement is implemented and how it works in practice. In fact, any introduction of new tools on concentration would duplicate existing requirements.
- Paragraph 105: **The industry strongly supports the PPP and does not believe any changes are necessary. It does not support any changes or enhancements which would result in rules and restrictions.**
- Paragraph 106: The industry agrees that insurers have to take macroeconomic and financial developments into account in their investment decisions. However, the PPP already requires insurers to invest their capital in a way in which security, quality, liquidity and profitability of the portfolio as a whole are ensured. In particular, Article 260 on Risk Management Areas of the Solvency II Delegated Regulation requires the risk management function to consider "possible risks of contagion between concentrated exposures". That means that insurance companies already have to consider potential risks to the integrity and stability of financial markets in their investment strategies, including all observable systemic risks which could have a material impact on their business. Should any enhancements be considered by EIOPA for the PPP, then care must be taken to avoid creating conflicts which would prevent insurers from acting in the best interest of their policyholders.

11.4.6 Systemic risk management plans

- Paragraph 120: **Systemic Risk Management Plans (SRMPs) may, in some cases, offer a useful way for insurers to take corrective action on systemic risk before supervisory measures are necessary, but these need to be justified by clearly quantified and articulated evidence of material systemic risk in advance, with a clear commitment to proportionality**. **Therefore, SRMPs should be seen as a reserve tool, and its use should be contingent on the identification of material levels of systemic risk and evidence of a clear transmission channel into the wider economy from the identified activity.** Only to the extent that an SRMP is considered relevant and to avoid additional reports, such analysis could be included in the ORSA report.

11.4.7 Liquidity risk management planning and reporting

- Paragraph 140: **Because liquidity risk is important but not a primary risk for the wider insurance sector, any request of such plans should be applied subject to the proportionality principle on activities that could generate unexpected liquidity needs**. The industry would point out that liquidity risk is already explicitly mentioned in Article 44 of the Solvency II Directive and is monitored by insurers. Additional normalisation efforts and validation processes should take existing requirements and practice into account and not increase the reporting burden without significant added benefit. EIOPA considers the costs for the implementation as not significant, especially for large insurers or conglomerates. However, more

reports and information requirements could produce significant administrative burdens and may require additional IT investments at the expense of insurers and, ultimately, policyholders. A comprehensive cost-benefit analysis would therefore be required. Any request for LRMPs should be duly justified and be applied subject to the proportionality principle. This would be also in line with the IAIS Holistic Framework, which requires more detailed liquidity risk management processes and reports only for insurers with activities that could generate unexpected liquidity needs (see ICP 16.9).

11.4.8 Temporary freeze on redemption rights

- Paragraph 145: Supervisory and/or management actions should be considered when faced with the extremely remote risk of mass surrender, as such actions can be effective in controlling liquidity risk. More specifically, in many cases insurers have the contractual ability to delay surrenders and/or resolution authorities have the power to apply temporary stays. In fact, it is no coincidence that in markets where products have flexible surrender options supervisors typically have the power to intervene. Such powers must be taken into account when assessing the actual systemic risk because they serve as an important transmission blocking mechanism.
- Paragraph 160: While the industry believes that only tools/measures specifically mentioned in the EC CfA should be further considered, **it views the power of supervisors to temporarily freeze redemption rights as a potentially useful tool because it would address the extremely remote risk of mass surrender, preserving value and potentially preventing the need to use more drastic measures within the resolution toolkit. Besides, it could prevent the unequal treatment of customers who surrender their policy in a crisis and those who do not. In addition, this tool has proven its effectiveness in the few cases when it was used.** Nevertheless, the only potential circumstance in which such a tool could be useful is when there is a real and imminent risk of an insurance run (mass lapse); although mass lapses are extremely unlikely in practice, such powers would create an absolute limit to insurers' exposure to very significant forced "fire sales" of assets and contagion. In the unlikely case of individual company mass lapses, supervisors are, in any case, able to intervene unilaterally after the SCR has been breached as part of the ladder of intervention. Intervention should only be possible before the SCR has been breached if requested by the company. The industry would add that stay and suspension powers could not only be applicable to cashing out policies, but also to switching. This is one of the very few areas where changes to the existing situation can be justified to ensure that all supervisors across Europe have the necessary stay and suspension powers. However, this strong tool has to be handled with great care, especially when it comes to disclosure, in order to avoid undesirable side effects. Because even temporary freezes constitute an infringement of property rights of policyholders, they should only be applied under clear and precise conditions that also adhere to relevant ECJ jurisprudence.

11.4.9 Other measures – enhancing the reporting framework from a macroprudential point of view

- Paragraph 165: **The industry does not believe any enhancements in the reporting framework, already very burdensome, are needed.**
- Paragraph 168: At this stage, the industry does not see a need for additional measures in the reserving process. With Solvency II, the best estimate calculation of the technical provision has been introduced. To ensure the adequacy of technical provisions, insurers must validate the entire calculation. This includes the appropriateness, completeness and accuracy of relevant data, the adequacy of the assumptions and methods and the appropriateness of the level of the technical provisions with respect to all the obligations towards the policyholder. In addition, the risk margin provides an extra layer of security. The responsible actuarial function is required to be independent of the revenue-generating functions and kept free from the influence of the management board. Sufficient evidence for the management board should be included within the Actuarial Function Report to rely on the work carried out. The independent actuarial function must also give an opinion on the underwriting policy, including an analysis of the sufficiency of premiums to cover future claims and expenses. Regarding the supervisory authority, companies already provide sufficient information on the adequacy of their reserves in the regular supervisory report (RSR) and, in many member states, an external auditor has to audit the Solvency II balance sheet, including technical provisions. Enhanced monitoring against market-wide under-reserving would likely create additional reporting requirements and

make the reserving process more cumbersome. It is difficult to understand how this would protect against systemic risk. EIOPA has not provided evidence of under-reserving that would lead to systemic risk concerns.

Q11.1: What principles should be taken into account by NSAs in their decision to trigger, set, calculate and remove capital surcharge for systemic risk?

- The industry strongly opposes awarding supervisory powers to apply new capital surcharges for systemic risk. Capital cannot be the default response to systemic risks. Instead, where real systemic risk exists, other mechanisms, such as ensuring supervisory oversight and good internal controls and risk management, are essential. Given the comprehensive nature of Solvency II, risks which could lead to systemic concerns (such as losses in asset portfolios or mass customer policy surrenders), are already covered. Therefore, it is unclear why there would be a need for additional capital.

Q11.2: What factors should be taken into account by NSAs when setting soft thresholds at market-wide level?

- The industry does not agree that the **calibration of "soft" thresholds** at company level could contribute significantly to the mitigation of systemic risk. It is difficult to see this as a macroprudential tool. Instead, the industry supports existing market-wide monitoring exercises and stress testing for the purpose of macro-prudential analysis.
- Because Solvency II is already an advanced risk-based regime, it is unclear why "soft" thresholds are necessary; firms with a larger asset concentration also address risks through their ORSAs.
- To the extent that thresholds trigger supervisory actions, they cannot be considered "soft". EIOPA also does not explain what these actions are and what "at market-level" exactly means. This proposal could also give intervention powers to NSAs when the SCR is not breached, which is not acceptable. Furthermore, "soft" thresholds could easily lead to de facto "hard" thresholds being imposed on individual firms, based on market-wide benchmarking.

Q11.4: What are the relevant factors to be taken into account to determine the scope of undertakings subject to SRMPs?

- **Systemic Risk Management Plans (SRMPs)** may offer a useful way for insurers to take corrective action on systemic risk before supervisory measures are necessary, but these need to be justified by clearly quantified and articulated evidence of systemic risk in advance, with a clear commitment to proportionality. Applying SRMPs to all firms without reference to their specific risks would likely prove unnecessary and irrelevant.
- It is important that SRMPs are not required by default of the largest firms, but only in those cases where there is clear evidence of material systemic risk.
- Such plans could entail significant operational costs for insurers if they become overly prescriptive and so the contents of SRMPs should be largely determined by insurers themselves. Instead of producing yet another standalone report, it could make more sense in some cases, when an SRMP is relevant from a systemic risk perspective, for the analysis to be included into the ORSA report.

Q11.5: What are the relevant factors to be taken into account to determine the scope of undertakings subject to LRMPs?

- The industry considers it appropriate that such plans are required at the discretion of the group-wide supervisor. However, any request for LRMPs should be duly justified and be applied subject to the proportionality principle. This would be also in line with the IAIS Holistic Framework, which requires more detailed liquidity risk management processes and reports only for insurers with activities that could generate unexpected liquidity needs (ICP 16.9).

12. Recovery and resolution

With respect to EIOPA's proposals relating to pre-emptive recovery planning, these seem to be broadly in line with the holistic framework, however a risk-based approach and proportionality are essential. It is important to ensure that this requirement is only applied to companies where planning would create a tangible benefit in terms of reduction of material systemic risk at EU level, not least because Solvency II already requires recovery planning from all companies when the SCR is breached. Therefore, there should be no requirement regarding recovery and resolution plans based on the coverage of the market share of the national market.

With respect to resolution measures, there is no justification for going beyond the global holistic framework. The industry also highlights that run-offs and portfolio transfers are sufficient to deal with the large majority of insurance failures. Therefore, the more drastic measures within the resolution toolkit proposed by EIOPA should be considered with caution.

There is no need for supervisory intervention in the day-to-day operations of healthy companies, in particular the removal of impediments for recovery and resolution and early intervention rights. Otherwise, Solvency II would be undermined under the guise of recovery and resolution requirements.

Section 12.2 Identification of the issue

- Paragraph 16-17: The existence of diverging approaches in the member states is not a valid reason for introducing a very burdensome EU-framework on recovery and resolution for insurers. In addition, such a framework would to some extent be in conflict with the principles of proportionality and subsidiarity according to article 5 in the Treaty on European Union (TEU).
- Paragraph 17: Just because the BRRD was adopted for the banking sector does not automatically mean that insurance recovery and resolution frameworks need to also be harmonised.
    - Insurance differs fundamentally from banking and this fact has a significant impact on both the need for, and design of, recovery and resolution tools. If this is not taken into consideration, applying the same recovery and resolution framework/tools as for banks to insurers can have materially negative impacts on the insurance industry, policyholders and in the end the whole economy.
    - Insurance failures are rare and do not affect other insurers or the payments system. Should an insurer fail, there is also no convincing evidence of a lack of substitutability of products that would justify the introduction of additional measures.
    - Unlike in banking, insurers do not fail suddenly as insurers' liabilities crystallise gradually over time, allowing for a structured wind-down, so that policyholders are unlikely to be left without cover. In addition, insurance liabilities are largely independent of each other, and are not 'callable' on demand since an insurance liability occurs at a specified point in time or following a pre-defined insured event. Hence, systemic risk is significantly lower in insurance than in banking.
    - The unique characteristics of the insurance business model stand in clear contrast to those of banks; resolution approaches should closely reflect that. The key difference between a bank's resolution and an insurer's resolution is that the latter can be managed over an extended period. There is no need to rush into resolution, particularly because doing so could generate avoidable losses for policyholders. In addition, the EU insurance sector consists, to a significant degree, of mutual insurance companies and other cooperatives, which must be taken into consideration in a recovery and resolution framework for insurers.
- Paragraph 19: Cross-border cooperation and coordination between supervisory and/or resolution authorities can indeed be reinforced, as well as the mutual recognition of resolution actions. But measures to this effect can also be introduced in the absence of a harmonised framework for recovery and resolution at EU level.

Section 12.3 Analysis

- Box 12.1: The figure presenting the crisis management flow should be amended to reflect that early intervention does not currently exist and neither should it be mandated. Rather, the second bubble on the top row should reference "Early warning indicators" whereas the second rectangle on the bottom row should refer to "increased monitoring and dialogue". **There should be no early intervention points for supervisors as long as the SCR has not been breached.** The mechanism of Article 136/136 of the Solvency II Directive (notification of the supervisor in deteriorating financial conditions and submission of a recovery plan within 6 months of the breach of the SCR) should be sufficient. In addition, under Solvency II the SCR is a solvency target and not a minimum floor. Breach of SCR should not mean nor be interpreted as the firm being in peril but rather as an early warning for firm's remediation actions. Extending early intervention powers on top of the existing intervention ladder is inconsistent with the SCR being a target and would conversely make it the *de facto* MCR.
- Box 12.2: In response to comments made on reinsurance, the industry would note that reinsurance is a business-to-business activity, with limited policyholder protection implications, and there is no evidence or history of it contributing to systemic risk or financial instability. The application of regulation to reinsurance needs to be proportionate.
  - Regarding entity-based systemic risk, the 3 biggest reinsurers in the EU combined total assets represent 0.1% of the total financial assets in the world (as computed by the FSB in the *2018 Global monitoring report on NBFI)*. The 10 biggest global reinsurance groups represent no more than 0.3% of the total financial assets in the world.
  - Regarding activity-based systemic risk, reinsurance is primarily about property, casualty and biometric risks. Those risks are not linked to the financial cycle and therefore traditional reinsurance activities are not subject to "bank-run" or risk of fire sales.
  - Regarding behaviour-based systemic risk, reinsurance activity covers in particular long tail risks and thus, from an ALM perspective, reinsurers invest through the cycle and are not prone to herding behaviour.

  Many of these arguments related to reinsurance also apply to primary insurers.
- Paragraph 47: The industry believes that, at this stage, it is not demonstrated that normal administration/insolvency procedures would be unsuitable to deal with insurance failures or that existing powers and tools have been inadequate. EIOPA has not made a convincing case in its Opinion or in its draft Advice. Therefore, the industry believes that any potential harmonisation could only be principle-based. In many cases, there are justifiable reasons as to why different approaches are taken in different jurisdictions. Minimum harmonisation efforts are already led by the Financial Stability Board, which includes recognition of national differences. Insurance regulation is not an appropriate route to achieve harmonisation of company law, which at a national level may include tools to achieve resolution of insurance companies. Thus, any new EU-framework on recovery and resolution should include the option for the member states to determine the appropriate approach for their market.
- Pre-emptive recovery planning should indeed be developed at group level.
- Paragraphs 73-76: The industry welcomes EIOPA's explanation of how the proportionality principle will be applied when requiring pre-emptive recovery plans from insurers. Indeed, the proportionality principle should ensure that healthy firms that can withstand (severe) stress scenarios are not required to devote unnecessary resources developing such plans when the relevance of doing so is rather limited and could be counter-productive where it acts as a distraction from more effective preventive measures. Correct application of proportionality will therefore mean very few insurers would actually be required to develop such plans.
- Paragraph 77: **The industry believes that pre-emptive recovery planning should only be considered for insurers with higher risk where it would provide a tangible benefit, as determined by the relevant supervisory authority. Subject to this condition, pre-emptive recovery planning can be a sensible addition to ORSA requirements, but it should be insurers who draft these plans, not subject to supervisory direction to set the elements of the plan.**

- Paragraph 78: Having requirements of national coverage will lead to a situation in which many other insurers, some quite small, would be required to have pre-emptive recovery plans to satisfy market coverage criteria. In addition, requirements of coverage are in conflict with the proportionality principle and the possibility to waive undertakings from the requirement of pre-emptive recovery planning. **The industry is therefore strongly against the proposal that the requirement to have pre-emptive recovery plans should capture some specific share of each national market in the EU.**
- Paragraph 79: The industry welcomes the harmonised criteria for waiving undertakings from the requirement of pre-emptive recovery planning and stresses that pre-emptive recovery planning should not be a permanent requirement. Healthy firms for which a breach of the SCR under a (severe) stress scenario is not a likely outcome should not be required to formalise a pre-emptive recovery plan. A risk-based approach needs to consider the probability of a crisis of the individual undertaking or group and the potential impact of that crisis on the financial market. Insurers with a low probability of crisis (e.g. adequate coverage ratio, less complex risk profile) and whose failure or subsequent winding up is unlikely to have a material impact, should not be obliged to draw up a pre-emptive recovery plan. Substitutability is not a suitable criterion and its inclusion could be counterproductive. In particular, it might disincentivise product offerings in highly concentrated markets and could lead to a more restricted product range, e.g. in marine, aviation or export credit insurance.
- Paragraph 80: The industry supports the application of proportionality. Authorities should be permitted to apply different or significantly reduced recovery planning and information requirements on an undertaking-specific basis. For a less complex undertaking or group, a recovery plan could be reduced to some basic information on its structure, triggers for recovery actions and recovery options, for example based on a standardised template.
- Paragraph 90: In the industry's view, it is not suitable to apply early intervention powers when the SCR is above 100%. These powers may be useful if a company is in freefall, but the supervisor should have to prove that this is indeed the case. Solvency II (through the ladder of supervisory intervention) already enables supervisors to step in when there is an imminent risk that capital requirements are breached. Further anticipating regulatory intervention is hardly justifiable in terms of proportionality and would undermine a cornerstone of Solvency II crisis management. It would also add another layer of solvency requirements beyond the already very prudently set 99.5% VaR over a 1-year horizon, and thus introduce legal uncertainty in relation to the prudential framework for insurers. It should also be noted that early intervention could negatively impact the reputation/value of an insurer in a manner that could exacerbate its difficulties. The industry believes that EIOPA should clearly state the situations that would justify early intervention and explain why the ladder of intervention provided by Solvency II would not suffice to deal with them. In fact, the Solvency II SCR is a solvency <u>target</u> and <u>not</u> a minimum floor. Breach of SCR should not mean nor be interpreted as the firm being in peril but rather as an early warning for a firm's remediation actions.
- Paragraph 92: While the industry believes that only tools/measures specifically mentioned in the EC CfA should be further considered, it views the power of supervisors to temporarily freeze redemption rights as a potentially useful tool because it would address the extremely remote risk of mass surrender, preserving value and potentially preventing the need to use more drastic measures within the resolution toolkit. In addition, this tool has proven its effectiveness in the few cases when it was used. Nevertheless, the only potential circumstance in which such a tool could be useful is when there is a real and imminent risk of an insurance run (mass lapse); although mass lapses are extremely unlikely in practice, such powers would create an absolute limit to insurers' exposure to very significant forced "fire sales" of assets and contagion. In the unlikely case of individual company mass lapses, supervisors are, in any case, able to intervene unilaterally after the SCR has been breached as part of the ladder of intervention. Intervention should only be possible before the SCR has been breached if requested by the company. The industry would add that stay and suspension powers could not only be applicable to cashing out annuities, but also to switching. This is one of the very few areas where changes to the existing situation can be justified to ensure that all supervisors across Europe have the necessary stay and suspension powers. At the same time however, this strong tool has to be handled with great care, especially when it comes to disclosure, in order to avoid undesirable side effects. Because even temporary freezes constitute an infringement on policyholders'

property rights, they should only be applied under clear and precise conditions that also adhere to relevant ECJ jurisprudence.

- Paragraph 97: Applying proportionality when considering early intervention powers is of course important. But the industry is not convinced that early intervention powers are necessary at all. EIOPA should clearly state the situations that would justify early intervention and explain why the ladder of intervention provided by Solvency II is not sufficient to deal with them, keeping in mind that the SCR is a target and not a minimum floor.
- Paragraph 98: In the industry's view, it is not suitable to apply early intervention powers when the SCR is above 100%. EIOPA should clearly state the situations that would justify early intervention and explain why the ladder of intervention provided by Solvency II is not sufficient to deal with them. According to Article 34 of the Solvency II Directive, an NSA could take any necessary preventive and corrective measures to ensure that (re)insurance undertakings comply with the laws, regulations and administrative provisions. Additional early intervention powers without identifiable infringements against any law or regulation should be avoided.
- Paragraph 99: Additional early intervention powers without identifiable infringements against any law or regulation should be avoided. The industry is particularly critical with respect to the additional powers to implement within a specific timeframe one or more measures set out in the (up-dated) pre-emptive recovery plan (12.90) b); or in case of no pre-emptive recovery plan, further measures to overcome any problems (12.90 c) and the power to limit variable remuneration and bonuses (12.90 d). Such far-reaching measures should be implemented in the event of recovery and foremost on the basis of management decisions.
- Paragraph 104: The industry disagrees with EIOPA's advice that member states should have in place an officially-designated administrative resolution authority. This is inconsistent with the guidance on the resolution of insurers in Annex 2 of the FSB's Key Attributes for effective resolution regimes. This notes that references to a 'resolution authority' include a reference to more than one authority where multiple authorities are responsible for exercising resolution powers under the resolution regime.
- Paragraph 109: Policyholder protection is the very purpose of prudential regulation; the current level of protection offered by Solvency II and national insolvency law already provides very adequate safeguards. In particular, the SCR ensures a high level of protection for policyholders, and Solvency II already provides for the development of recovery plans when the SCR is breached, ie long before there is a real risk that policyholders will not be protected in full. Resolution authorities should balance the objectives of resolution appropriately.
- Paragraph 116: The industry believes that the operational resolution plans need to be tailored to the circumstances of the insurer and should also be flexible, allowing authorities to consider the circumstances of resolution. At the same time, overreliance on resolution plans may obstruct the clear view on the causes for a crisis and the adequate measures to cope with them.
- Paragraph 117: The resolvability assessment should consider how, in the unlikely situation in which an unpredictable event has led an insurer to a point of non-viability that it cannot recover from, policyholders' interests can be best protected. The resolvability assessment should be discussed with the insurer.
- Paragraph 118: The power to require the removal of significant impediments to the resolvability of an insurer should be considered with restraint. Requiring the removal of impediments means that the competent authorities interfere with the legal structure of the insurer. This would be a massive intervention that is only justified under exceptional circumstances. It is also important, as EIOPA notes, that there are safeguards surrounding the use of such power to provide appropriate checks and balances, and a mechanism by which an insurer can challenge and seek impartial review of the proposed use of this power. It should also be noted that the power to remove impediments to resolvability is of lesser relevance in an insurance context, given the timeframe over which insurer resolutions can take place (e.g. systems do not have to be ready for resolution over the weekend, such as with banks). The decision to impose any such requirement should take due account of the effect on the soundness and stability of ongoing business.
- Paragraphs 130-132: The industry welcomes EIOPA's explanation of how the proportionality principle will be applied in the context of pre-emptive resolution planning.
- Paragraph 133: To ensure realistic assumptions and decisions, the resolution plan drafting process should be transparent to the concerned undertaking. The rules on how such a resolution plan should be established must be published. At the same time, readily available information should be used and additional requests

of information from the insurer should be minimised in order to avoid an excessive unjustified burden. The request of completely new data or valuation methods ("gone concern") from the insurer should be avoided as these would require a fully different approach in addition to the existing supervisory, tax and commercial valuations.

- Paragraph 134: The industry agrees with EIOPA that the scope of pre-emptive resolution planning should be narrower than the scope of pre-emptive recovery planning as resolution is only necessary if recovery measures have already failed. Nevertheless, **the industry is strongly against the proposal that the requirement to have pre-emptive resolution plan should capture some specific share of each national market in the EU.**
- Paragraph 136: The industry supports the application of proportionality, but this should be subsequent to the risk-based approach. Only for individual or groups of companies undertaking systemic activities, a pre-emptive resolution plan should be drafted. If drafting such a plan is required, the industry agrees that proportionate simplifications (e.g. less content and lower frequency to report to the NSA) of the resolution plan should be feasible.
- Paragraph 137: The industry disagrees with the proposed power to remove significant impediments to the resolvability of undertakings at the request of the authority. This would mean that the company's business strategy could be interfered with in the ordinary course of business a long time before a potential crisis may or may not appear. The company's strategy and governance structure must be aligned with the market and policyholder needs and comply with relevant laws, regulations and administrative provisions. According to Article 34 of the Solvency II Directive, supervisory authorities are already empowered today to take any necessary preventive and corrective measures to ensure that insurance and reinsurance undertakings comply accordingly. It makes no sense to align the corporate structure of an entity or a group with potential smooth resolution processing. There is a clear risk that reasonable and efficient measures, like centralisation of processes and systems or intra-group transactions will not have to be implemented at all or even be reversed.
  - On the one hand, such interventions could have far-reaching consequences in other areas such as corporate and tax law, but also on investor relations and ratings. It’s not unlikely that concerned insurers will suffer competitive disadvantages in the long-term. Likewise, policyholders would incur additional costs or loss of returns.
  - On the other hand, a crisis in the traditional insurance business normally offers enough time to implement necessary crisis measures and remove significant impediments. Against this background, interventions in a healthy company by an authority should remain an exemption and only take place when absolutely necessary. They would have to be used very carefully and in a transparent way. The resolution authority should closely coordinate and first give the insurer the opportunity to propose its own solution to removing the impediment to resolvability.
- Paragraph 147: The industry agrees with these safeguards.
- Paragraph 150: **The industry believes that run-offs and portfolio transfers are sufficient to deal with the large majority of insurance failures. Therefore, these should be the most preferred tools and authorities should clearly justify the need for more intrusive tools and why run-off or portfolio transfers are not sufficient to meet the objectives of resolution.** The industry would also like to re-emphasise that, since failures take longer in insurance, rapid intervention will not prove a good reason for the choice of resolution tools, especially because fire-sales of assets or the crystallisation of their value could result in unnecessary value destruction.
- Paragraph 155: EIOPA outlines that resolution authorities should be equipped with a broad set of resolution powers. These are already reflected in the FSB’s Key Attributes and it is not clear what value the EU’s replication of these standards achieves, beyond national implementation, especially considering that existing tools can often achieve similar outcomes without the need for more prescriptive harmonisation. It is proposed that national jurisdictions should also analyse in advance which implications the use of these powers generate for statutory reporting, corporate law and tax. Cross-border aspects should be included if necessary.
- The EIOPA consultation document does not include an analysis of the shortcomings of the current tools available. Without such an analysis, the industry challenges the need to introduce additional tools, with the exception of a proportionate requirement to draft ex-ante resolution plans. In particular, the tool allowing

supervisors to require,ex-ante, the removal of material impediments to resolution should be subject to a high threshold and thorough substantiation, taking into account that this is a tool that is potentially intrusive to the going concern and the generally remote likelihood of an insurance failure.

Figure 12.3 - the industry has the following comments with respect to the resolution powers listed here:

- **Control, manage and operate the insurer or bridge institution.** In a situation where the insurer is no longer viable, the power to continue to carry on some of the insurer's business, for example making payments to annuitants would be consistent with policyholder protection. However, the aim should be to establish appropriate adjustments in value, where required, as soon as practicable so as to prevent conflicts of interests arising between different policyholder groups. The industry agrees that control, management and operational powers are necessary, but would point out though that in insurance, establishing a bridge institution is another means to undertake a portfolio transfer.
- **Restructure, limit or write down liabilities, including insurance and reinsurance liabilities**, and allocate losses to creditors and policyholders, where applicable and in a manner consistent with statutory creditor hierarchy and jurisdiction's legal framework: Buyers of insurance purchase protection against financial losses that are incurred by the occurrence of the insured risk. Insureds pay a premium to mitigate risk, whereas investors take risk to earn a premium. Therefore, insureds are entitled to higher protection in resolution (and liquidation) than investors.
- **Restrict/suspend rights of reinsurer of a cedent insurer to terminate or not reinstate coverage on the sole ground of the cedent's entry in recovery or resolution:** The industry considers that this resolution power may be appropriate where the cedent enters resolution. It is however important to introduce adequate safeguards. Reinsurers should not be made liable to pay for losses beyond those covered by contracts existing at the time of the loss. Any reinstatement of coverage must be carried out at market prices. In the absence of comparable market prices, the reinsurer should be able to use its existing pricing mechanisms. Reinsurers can provide valuable capacity in off-loading risk. Where the implementation of such a framework creates legal uncertainty or moral hazard risks in the case of recovery this could limit reinsurers' willingness to get involved when firms are in financial difficulty.
- **Stay on early termination rights associated with derivatives and securities lending transactions**. Great care must be taken with regard to the possible effects on assets or investments, including existing contracts. In addition, a comparison with the existing regulations at the European level is absolutely necessary. Otherwise there could be contradictory regulations. It is also important to point out that this resolution power will most likely lead to higher costs for insurers to use derivatives to manage and mitigate their risk.
- **Ensure continuity of essential services (e.g. IT) and functions by requiring other entities in the same group to continue to provide essential services to the undertaking in resolution, any successor or an acquiring entity**. Contagion effects may be expected from other group companies if they continue to have to provide services for the insurance company in resolution and may not receive adequate payments for these services.

- Paragraph 157: The industry agrees with these safeguards, but reasonable deviations must be possible.
- Paragraph 166: The industry agrees with the concept of cooperation agreements and believes that cooperation and coordination between relevant supervisors and resolution authorities within the EEA and third countries is important. Unilateral decisions should be explicitly discouraged, as they risk producing sub-optimal outcomes. Such cooperation and coordination between supervisors should allow for the swift recognition and implementation of decisions of resolution authorities outside their jurisdictions, thereby increasing their chances of success. Cross-border issues will not be addressed through harmonised resolution powers, but rather through COAGs between respective authorities.
- Paragraph 167: It should be assessed whether improving cooperation between European authorities necessarily requires a legal initiative – or whether this goal could also be achieved by further developing cooperation agreements between authorities, as in the case of the existing supervisory colleges under Solvency II.

Q12.1: How should the very significant market coverage across the Member States be determined? What are relevant factors to take into account?

- With respect to EIOPA's proposals relating to pre-emptive recovery planning, these seem to be broadly in line with the holistic framework, however a risk-based approach and proportionality are essential. It is important to ensure that this requirement is only applied to companies and where planning would create a tangible benefit in terms of reduction of material systemic risk at EU level, not least because Solvency II already requires recovery planning from all companies when the SCR is breached. Therefore, there should be no requirement regarding recovery and resolution plans based on the coverage of the market share of the national market.
- To have requirements of national coverage will lead to a situation in which many insurers, will be required to have recovery plan to satisfy market coverage criteria. In addition, requirements of coverage are in conflict with the proportionality principle and the possibility to waive undertakings from the requirement of pre-emptive recovery planning. The industry is therefore strongly against the proposal that the requirement to have recovery plan should capture some specific share of each national market in the EU.

Q12.2: How should the significant market coverage across the Member States be determined? What are relevant factors to take into account?

- With respect to EIOPA's proposals relating to pre-emptive resolution planning, these seem to be broadly in line with the holistic framework, however a risk-based approach and proportionality are essential. It is important to ensure that this requirement is only applied to companies where planning would create a tangible benefit in terms of reduction of material systemic risk at EU level. Therefore, there should be no requirement regarding recovery and resolution plans based on the coverage of the market share of the national market.
- The industry does not think that there is a benefit to developing a pre-emptive resolution plan for an apparently healthy insurance company. In general, it would make sense that resolution authorities develop a generic overview of resolution options with their pros and cons, in order to facilitate the assessment of the situation and the drafting of a recovery plan in case a company breaches the SCR.
- To have requirements of national coverage will lead to a situation in which many insurers, will be required to have recovery plan to satisfy market coverage criteria. In addition, requirements of coverage are in conflict with the proportionality principle and the possibility to waive undertakings from the requirement of pre-emptive recovery planning. The industry is therefore strongly against the proposal that the requirement to have a recovery plan should capture some specific share of each national market in the EU.

Section 12.4 Triggers

- Paragraph 181: With respect to triggers for early intervention, Solvency II coverage as provided by the directive is by far the most accurate determinant of an insurer's financial condition and of its ability to meet claims to policyholders.
- Paragraph 183: The industry agrees that no new intervention level should be established. To avoid early intervention powers resulting in a new pre-defined intervention level or an implicit new capital requirement, it has to be clearly stated that supervisory intervention should not take place before the SCR is breached (or there is a risk of non-compliance within the next three months).
- Paragraph 189: **The SCR is already an early intervention trigger**. Even if the respective undertaking is in breach of the SCR, it can still dispense with sufficient own funds to meet all its obligations. However, at this early stage the supervisory authority is already empowered to use very extensive supervisory instruments to react. According to Article 34 of the Solvency II Directive it could take any necessary preventive and corrective measures to ensure that insurance and reinsurance undertakings comply with the laws, regulations and administrative provisions. At the same time, affected undertakings need to draw up a recovery plan within two months and present it to its supervisor for approval. In addition, it needs to re-establish a sufficient level of eligible own funds within six months or reduce its risk profile.
- Paragraph 206: The industry always maintained that rigid pre-defined triggers (an absolute obligation for the authority to intervene when a specific situation arises) for entry into resolution are not appropriate, as

an assessment of when an insurer's liabilities exceeds its assets requires significant judgment on the part of the resolution authority (this is because asset values fluctuate and so do liabilities, which are merely best estimates of expected claims/maturities rather than certain amounts). The industry believes that it is important to avoid disrupting the ladder of supervision already provided by Solvency II.

- Paragraph 207: While it is essential that a resolution framework provides strong legal certainty for undertakings, the industry believes that flexibility is important when determining points (and underlying conditions) of entry into resolution. It is necessary that resolution authorities have enough flexibility to also determine the most appropriate resolution strategy conducive to the optimal outcome for the point of entry they choose (as opposed to being bound by the original strategy). The development of a preferred resolution strategy that best achieves the resolution objectives may depend on many factors, such as the existing structure and business model, the need for recapitalisation, the necessity for preservation of diversification, or the degree of internal interdependencies within the group. Not making use of some resolution tools may even be the best solution, as insurance resolution normally does not have the same urgency as bank resolution.
- Paragraph 208: the inclusion of "likely" in the first trigger should be removed as it introduces uncertainty. The condition should be aligned to the Solvency II ladder of supervisory intervention, and therefore should refer to an irrecoverable breach of the MCR.

Q12.3: What factors need to be considered by NSAs for early interventions?

- There is no need for triggers for early intervention as Solvency II already provides for a supervisory ladder of intervention, and a breach of the SCR should not be seen as a trigger for the application of supervisory intervention measures. Solvency II is by design a risk-based and forward-looking framework. Consequently, there is no need for early intervention as the framework implies sufficient time to react in case of an SCR breach. The existing supervisory ladder of intervention as defined by Solvency II is sufficient, in particular in view of Article 141 of the Solvency II Directive, which grants comprehensive rights to NSAs in case of a deteriorating solvency position. It is not necessary to include further early intervention triggers in EU legislation, especially if they are judgement-based as proposed by EIOPA.
- An insurer with below 100% SCR is still clearly solvent and above Minimum Capital Requirement (MCR) and so intervention at the SCR breach would likely push supervisors towards short-termism in their approach to supervisory intervention measures, which is inappropriate given the long-term nature of insurance. An SCR breach should trigger a conversation between a firm and its supervisor to discuss recovery options, starting with management actions within the discretion of the firm (capital raising, sell off a book of business).
- The industry welcomes EIOPA's clarification that new early intervention points based on a solvency ratio above the Solvency Capital Requirement (SCR) should be avoided, however this seems to suggest that supervisors will instead use their own judgement to determine when early intervention is required. This allows too much discretion for supervisors to intervene at a point when an insurer is clearly meeting Solvency II 1-in-200-year capital requirements.
- There is no need for resolution triggers as this is already provided under local legal frameworks and would generally be linked to capital insolvency or default of payments. Therefore, no action by EIOPA in this area is necessary.

Q12.4: How could resolution authorities determine whether undertakings are *likely* to be no longer viable and have no reasonable prospect of becoming so?

The inclusion of "likely" in this trigger should be removed as it introduces uncertainty. The condition should be aligned to the Solvency II ladder of supervisory intervention, and therefore should refer to an irrecoverable breach of the MCR.

13. Insurance guarantee schemes

The separate consultation on IGS is led by IGS PG (reporting to EXCO).

14. Other topics of the review (transitionals, fit & proper)

The industry supports no changes in the areas of other transitionals

In relation to fit ad proper requirements, the CfA was intended to solve cross-border issues. Pillar 2 is not in the scope of the 2020 review. In any case, the regulation already provides what is needed to ensure ongoing appropriateness, and the pursued goal of these changes is unclear.

Section 14.1 Other transitionals

- Paragraph 37: The industry welcomes EIOPA's advice to not change the transitional measures of Article 308 (b) (15).

Section 14.2 Fit and proper requirements

- Paragraph 49: Art. 42 SII Directive, Art.273 of the Delegated Regulation and Guideline 11 on system of governance, require the insurance undertaking, but not the NSA, to ensure that the requirement is met at all times. This should not be changed because a regular ongoing assessment by the supervisor does create a lot of bureaucracy and redundancy, with little value where it is not based on new facts or evidence that this is needed. A regulatory ongoing assessment by the supervisory authority can be expected to create cost in addition to the cost already created by the internal assessment. It should rather be considered to state an obligation of the undertaking to notify the supervisory authority if the undertaking's assessment has led to a negative result. As part of the general powers to supervise the system of governance of the undertaking, the NSA already has the necessary powers to investigate in case of doubt, to supervise the ongoing assessment process of the undertakings, and to require the revocation of a person that does not meet the requirement pursuant to Art. 35 (1) a) (information right) and Art. 41 (5) (remediation of breach).
- Paragraph 50: The power to withdraw the authorisation in case of AMSB not being fit and proper should not be added as supervisory tool, because it is already contained in Art. 144 (c) of the Directive in case of a serious failure. As it should remain a last resort, a serious failure by the undertaking should be required and there should not be a specific regime for the failure to comply with the fitness & propriety, which is only one of many requirements. A better and more precise approach could be to ensure that NCAs have the power to revoke the members of the AMSB that are not fit and proper.
- Paragraph 52: A regular ongoing assessment by the supervisor does create a lot of bureaucracy and redundancy, but little value where it is not based on new facts or evidence. A regulatory ongoing assessment by the supervisory authority can be expected to create cost in addition to the cost already created by the internal assessment.
- Paragraph 55: The regulation requires the insurance undertaking, but not the supervisory authority, to ensure that the requirement is met at all times (see comment on paragraph 49). This should not be changed because a regular ongoing assessment by the supervisor does create a lot of bureaucracy and redundancy, but little value where it is not based on new facts or evidence. An ongoing assessment by the NSA can be expected to create cost in addition to the cost already created by the internal assessment. It should rather be considered to state an obligation of the undertaking to notify the NSA when the undertaking's assessment leads to a negative result. For the remainder, as part of the general powers to supervise the system of governance of the undertaking, NSAs already has the necessary powers to supervise the ongoing assessment process of the undertakings and to require the revocation of a person that does not meet the requirement pursuant to Art. 35(1)(a) (information right) and Art. 41(5) (remediation of breach).
- Paragraph 57: NCA already have the possibility to withdraw the license in case of non-compliance (Art. 144), therefore a cost reduction will not be achieved by any such power.
- Paragraph 58: The proposed clarification should be added in Art. 30(2) of the Directive, not in paragraph 1. System of governance is part of "financial supervision". The proposal set forth in paragraph 60 should therefore suffice.

- Paragraph 60 & 61: The necessity of this advice is not clear. As EIOPA points out in its peer review on propriety of AMSB members and qualifying shareholders from January 2019, Article 29 of the Solvency II Directive requires supervision to be carried out on an ongoing basis. This includes ensuring that the insurer carries out the assessment whether AMSB members and qualifying shareholders continue to meet the propriety requirements.
  Ongoing assessment of shareholders: There should not be an obligation for supervisory authorities to make an ongoing assessment of the fitness and propriety of the qualifying shareholders. Rather supervisory authorities should have (and have already today) the power to investigate in case of doubt. Especially with respect to large groups, an ongoing assessment would create immense bureaucracy for the supervisory authorities as well as for the undertakings with little to no added value. Where the ultimate parent of the group is considered as fit and proper, there should not be control at the level of intermediate shareholders.
  Art. 19 (3) SIID should not be amended as proposed. The qualifying shareholder should not become subject to obligations vis-a-vis the supervisory authority, as it is not a regulated entity (with the exception of the ultimate parent of the group, which is subject to group supervision). Therefore, the information requirement should be addressed solely to the relevant insurance undertaking, which is responsible for the completeness of its approval request.
  Withdrawal should be regulated only in Art. 62 (powers of supervisory authority with respect to qualifying holdings), not in Art. 24 (taking up of business). Furthermore, the withdrawal should be an option, not an obligation for the supervisory authority, as it should be a last resort and other means (restriction of voting rights) should be considered first. Therefore, Art. 62 (resp. paragraph 1, second sentence of Art. 24(1)) should read *"[…] may withdraw [...]".*
- Paragraph 64: A joint assessment will create even more bureaucratic burden at the side of NCA and of undertakings. Therefore, there should not be an exception to the principle of financial supervision by the home state supervisory authority.
- Paragraph 65: Powers of EIOPA should be in line with Regulation (EU) 1094/2010 and not go beyond.
- Paragraphs 67 & 68:The industry agrees with EIOPA's advice to encourage cooperation among NCAs in complex cross-border cases, as well as to enhance EIOPA's role as a facilitator in these cases. However, it would be inappropriate for EIOPA to act on its own initiative in this respect, unless NSAs require it or fail to reach agreement.
  Moreover, a joint assessment would dilute the responsibility of the competent NCA for the assessment of the fitness and propriety of the qualifying shareholder. While there should be exchange between NCA, the insurance undertaking should not be confronted with the information requests of several NCA. This would limit the principle of (prudential) supervision by the home state supervisor and, thus, the single license principle.
- Paragraph 68: According to paragraph 3.13 of the EC CfA, EIOPA is only asked to review the fit & proper requirements in the context of FoS/FoE issues. The amendment of Art. 26 (3) is not suitable to foster convergence in FoS/FoE. Art. 26 (1) requires an authorisation procedure for an undertaking. The host supervisor has no power for that. Therefore, EIOPA's advice misses the Commission's request.
  With respect to the definition of qualifying holdings, EIOPA should consider to provide more clarity and encourage supervisory practice in line with the SII-Directive. The current definition relies on three criteria: a) holding of at least 10% of voting rights, b) holding of at least 10% of capital, and c) significant influence. While regulation is striving to close possible gaps, there should also be a common understanding on holdings which can be disregarded.
  The "multiplication criterion" stipulated in the Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the banking, insurance and securities sectors is not in line with Art. 63 SII-Directive, which refers to Art. 10 (e) of the Transparency Directive (2004/109/EC) which clearly states the control criterion.
  With respect to holdings in the asset management sector, the parent undertaking of an investment firm or of a management company can disaggregate the voting rights relating to holding managed by the subsidiary (Art. 67 SII and Art. 12 (4) and (5) of the Transparency Directive). This necessary and appropriate disaggregation rule does not exist with respect to the holding of capital and the significant influence, but

should. The industry therefore recommends to review the definition of "qualifying holding" with respect to the comprehensive exclusion of holdings managed by asset management subsidiaries.

Annexes

Comments on annexes

- Paragraph 92 – Treatment of unrated bonds: exclusion from CQS allocation (alternative c) is our preferred option since:
  - Alternative a) cannot be applied to all types of unrated bonds (e.g. junior debt, bullet loans, mortgage loans) and is more burdensome
  - Alternative b) would be excessively prudent. E.g. unrated SME loans are generally allocated to BBB or BB ratings, which is also approx. the calibration under the SCR spread (cf. article 176§4 Delegated Regulation). An allocation to AAA may severely underestimate the illiquidity premia of unrated assets.
- Paragraph 172-174 – Static vs dynamic contract boundaries
  - The industry agrees that it is necessary to clarify the frequency of the reassessment in the Guidelines. The clarification should include the conclusions reached in A.172 and A.173, that the "reassessment of the contract boundaries should be limited to changes that have a significant impact on the assessment of discernible effect of covers, guarantees, limitations or restrictions", and that "the reassessment of the discernible effect should be limited to the assessment of contract boundaries at each valuation date".