Getting ready for the 2020 Solvency II review - EIOPA consults on its opinion

November 2019

Summary

EIOPA published its consultation paper on the 2020 review of the Solvency II regime (the consultation) on 15 October 2019. The consultation covers a wide range of topics in detail and builds on recent reviews on aspects of Solvency II, including reporting requirements, insurance guarantee schemes, as well as EIOPA's earlier advice on SCR standard formula changes. The consultation closes on 15 January 2020.

Key proposals include:

- **Resolving deficiencies in the volatility adjustment** (VA) by addressing scenarios where the VA exceeds the effect of a loss in the market value of fixed income assets and illiquidity characteristics of insurance liabilities (overshooting).
- **Group supervision**: clarifying the definition of an insurance group, increase powers available to regulators in relation to group supervision and proposing updates to governance expectations for groups.
- **Reporting**: reducing certain reporting and disclosure requirements and simplifying how to calculate capital requirements for immaterial risks in the standard formula to reduce the strain on small and medium-sized firms.
- Proposing the establishment of a **recovery and resolution framework** for insurers. Our recent At a glance discusses this topic in more detail.
- Introducing a **macroprudential** perspective within Solvency II to address systemic risk posed by insurers by granting regulators the option to levy a capital surcharge to mitigate systemic risks, requiring firms to consider macroprudential risks in their Own Risk and Solvency Assessment (ORSA) among other systemic risk considerations.
- **Risk margin**: Despite questions about its calculation, amendments to the risk margin have not been proposed.

It is unclear how the UK's regulatory regime might evolve after Brexit, including how closely aligned it remains with EU legislation such as Solvency II. The UK has brought Solvency II and other EU directives into UK law as part of Brexit preparations, but the extent to which it adopts or mirrors proposals after Brexit is unclear.
**Long Term Guarantee proposals**

**Interest rate extrapolation**

EIOPA discusses a range of options to mitigate the effects that the application of the ultimate forward rate (UFR), last liquid point (LLP) and the time to converge to the UFR exert on the extrapolated rates in the long-end of the risk-free curve. At present the Euro rate LLP is fixed at 20 years and this is considered to have a significant impact on underestimating the risk free interest rate and as a result technical provisions.

To address the issue EIOPA’s analysis focuses on the impact on Euro economies, where the LLP is set at 20 years (LLP is set at 50 years for the UK). EIOPA lays out the impact of increasing the LLP in different ways (to 30 and 50 years), including the pros and cons it identifies in these approaches as well as leaving the LLP at 20 years but introducing safeguards. These can include mandating sensitivity analysis of flexing the LLP to 30 and 50 years and publicly disclosing the solvency position under the different assumptions.

EIOPA observes that there is a higher degree of market depth, liquidity and transparency (DLT) at 30 years and that a sufficient level of DLT can also be found at 50 years.

In conclusion, all options (except for no change) would result in either:

- an increase in technical provisions for life insurers with long-dated non-sterling denominated liabilities (if moving the Euro LLP to 30 or 50 years), or
- requirement to publicly disclose the impact of extending the LLP to 50 years (sensitivity analysis) on the solvency position and the possibility that the regulator could curtail dividend distribution if it finds that under a 50 year LLP the insurer does not meet SCR.

**Matching adjustment**

EIOPA proposes removing the limitation to diversification benefits for matching adjustment (MA) portfolios in the SCR standard formula. EIOPA estimates that this option may generate capital savings for UK firms of between 0% and 6.15%. Firms using the MA under Standard Formula would likely see the greatest benefit, while full-internal model firms which have already removed diversification benefit restrictions would likely see no benefit.

EIOPA also seeks industry feedback on a proposal to clarify the MA eligibility for structured assets and assets where the cash flows depends on the performance of underlying assets. Under this proposal, and in addition to other MA eligibility criteria, firms are expected to demonstrate a sufficient production of fixed income from the underlying asset, loss absorbency features and appropriate process for managing risk. These proposals, which impact life insurers with MA, is in line with the PRA’s existing requirements in the UK for MA eligible assets as set out in SS7/18 Solvency II: Matching adjustment.

**Volatility adjustment**

The volatility adjustment (VA) aims to mitigate ‘artificial’ balance sheet volatility caused by short-term market volatility arising from exaggerations of bond spreads. However, EIOPA has identified a number of deficiencies in the design of the VA and sets out options to address these. Some of the deficiencies identified include:

- the VA more than compensating the loss in market value of assets due to widening spreads resulting in pro-cyclical investment behaviour
- the VA calculation is not sensitive to differing duration of insurance liabilities
- the country-specific component of the VA is triggered, suddenly resulting in cliff effects and over and under shooting of the VA impact.

Following extensive discussion of remedial options, EIOPA sets out two alternative approaches for changing the calculation of the VA based on a mix of options. Both approaches would seek to address the overshooting effects of the VA, as well as account for illiquidity features of insurance liabilities.

Approach 1 proposes a VA with two components: a permanent component with a more conservative impact reflective of the insurance liabilities of the entity and a macroeconomic component that only exists in times of wide spreads (crisis component). This would act as a buffer that directly impacts Own Funds rather than the interest rate. Approach 2 is based on an entity specific calculation that takes into consideration the entity asset allocation to avoid overshooting issues.

The VA is currently based on a general application ratio (GAR) of 65% which applies to all undertakings. EIOPA does not propose changing the GAR. However, the approaches it sets out include the possibility of scaling down or up the GAR on the basis of a firm’s own underlying investment portfolio mix or asset and liability management practices. These proposals would likely impact those firms which currently run a duration mismatch. While EIOPA acknowledges that both approaches could lead to additional complexity and costs associated with the application and supervision of the VA, it does not anticipate either leading to significant changes in SCR calculation.

EIOPA reconfirmed its current position that dynamic VA (DVA) should not be permitted for standard formula firms. DVA is primarily utilised by non-UK insurers with approved internal models and as such, is likely to have minimal impact on UK firms.

**Technical provisions**

EIOPA recommends altering the calculation of Expected Profits in Future Premiums (EPIFP) by amending the definition to include all future losses (i.e. to become an ‘Expected Profit or Loss in Future Premiums’), as well as including the impact of reinsurance. EIOPA notes that altering the calculation in this way could be burdensome for some firms and is seeking further information from stakeholders on the likely impact of this proposal. However, proposed changes to EPIFP would not have an impact on overall Own Funds or Solvency II balance sheet.

EIOPA has rejected the idea of aligning Solvency II technical provisions calculation to the IFRS 17 calculation for several reasons, including that the respective frameworks have different objectives and because IFRS 17 is still under review.

No changes are proposed at this time to the risk margin calculation.
**Own Funds**

EIOPA has reviewed the differences in approaches to tiering structures of own funds in insurance (Solvency II) and banking (CRD IV). It found that differences in approaches between the two capital frameworks are justified due to sectoral differences, and because the way losses are absorbed by banks and insurers vary significantly. As a result, no changes were proposed.

**Solvency Capital Requirement (SCR) standard formula**

As part of its 2018 advice on SCR standard formula changes, EIOPA noted the current stress method underestimates interest rate risk (IRR) in low and negative interest rate environments. As a result, EIOPA proposed moving to a ‘relative shift’ approach for interest rate risk, which it has now reconfirmed in this consultation paper. This change in approach is likely to result in a higher capital requirement for this module.

EIOPA has proposed not to modify the existing spread risk sub-module, standard formula correlations and property risk calibration among others.

Building on previous advice to simplify the calculation of counterparty default risk within the standard formula, EIOPA proposes optional simplifications for computing the risk-mitigating effect of derivatives, reinsurance arrangements, special purpose vehicles and insurance securitisations, which were considered too burdensome. These proposals are intended to make calculations simpler for the counterparty default risk sub-module, but are unlikely to have a material impact on the capital requirements for most firms.

**Minimum Capital Requirement (MCR)**

EIOPA has recalibrated the parameters of the linear MCR calculation (i.e. before the application of floors and caps) for lines of business where the premium and reserve risk calibrations were changed for the SCR in 2019. The biggest changes proposed are for premium risk calibration for credit and suretyship which increased from 11.3% to 17.7%, and for legal expense cover where reserve risk calibration decreased from 11.3% to 5.3%. In the consultation EIOPA does not propose any changes to the MCR floor and cap which are currently set at 25% and 45% respectively. Therefore, changes in the MCR calibration for specific lines of business are unlikely to impact the overall capital requirements for most firms.

EIOPA proposes tightening up the ladder of intervention for non-compliance with the MCR. EIOPA proposals include requiring firms to immediately inform regulators when a breach in MCR is observed and not wait until the next quarterly reporting deadline to notify. EIOPA also proposes that firms should submit a financial plan to regulators outlining plans to restore their financial position within one month of a perceived risk of breach of MCR. This goes further than current requirements, under which firms must submit a financial restoration plan to its regulator within one month of an actual breach of MCR. These proposals are part of the wider recovery and resolution measures contained in the consultation, giving regulators early intervention powers.

**Proportionality**

EIOPA proposes to increase the threshold for firms captured under Solvency II by doubling thresholds for technical provisions to €50m and increasing the gross written premium threshold from €5m to up to €25m. These changes are aimed at reducing the financial and administrative burden on smaller firms by lowering their compliance costs. Smaller insurers should monitor developments in this area to assess whether they might fall outside the scope of Solvency II in the future.

The standard formula SCR consists of seven risk modules and 39 risk sub-modules. Some of the modules might be immaterial for a firm but the calculation for the SCR may be very complicated. EIOPA proposes to enhance proportionality by simplifying how to calculate capital requirements for immaterial risks in the standard formula. EIOPA also proposes to improve the proportionality of the Pillar 2 requirements. For example, EIOPA proposes an annual cycle for ORSA submission and to allow firms to combine certain key functions with operations functions.

**Group supervision proposals**

**Definition of a group**

EIOPA proposes to give regulators the power to designate insurers as a group if, in the opinion of the regulator (and not necessarily on the basis of a contract), related firms are effectively managed on a unified basis. EIOPA also proposes to...
give regulators powers to require groups to restructure if needed to exercise effective group supervision. Under the proposed new rules regulators would have legal powers such as suspending voting rights, issuing penalties, and restricting dividends over holding companies. Firms should review the potential impact of these proposals on their current group structures.

Designation as an Insurance Holding Company (IHC)

Current Solvency II rules are not clear regarding factors to consider for designation of a group as an IHC. EIOPA proposes that in addition to the common practice of using balance sheet thresholds (i.e. a group is deemed as an IHC if 50%+ of its balance sheet is represented by insurance firms) other indicators such as the SCR, equity, personnel, etc. should also be taken into consideration when defining an IHC. Firms should review the factors mentioned in EIOPA’s proposal and the level of interconnectedness of insurance companies with other parts of the group to assess if they are likely to be designated as an IHC.

Group solvency

Solvency II allows two ways of calculating Group SCR, Method 1 (deduction and aggregation) and Method 2 (accounting consolidation-based method). EIOPA clarifies the scope of entities included under Method 2 and their treatment to ensure a consistent application across methods. EIOPA’s proposals also seek to develop greater consistency with the FICOD Directive for group solvency calculations.

Group governance

EIOPA outlines certain expectations to provide clarity on how to set up a compliant and efficient governance system at group level. These include expectations that the group level ORSA and risk management system should cover all activities conducted at group level and that the ultimate parent company should monitor all its subsidiary entities in a proportionate manner.

Freedom to provide services and freedom of establishment

EIOPA proposes to alter the approach to supervising cross-border insurance within the single market. This takes place either on the basis of freedom of establishment (a firm in one Member State establishing a branch in another) or freedom of services (offering services in one Member State from another). These proposals would not apply to cross-border services from third countries to the EU and vice-versa. In particular, EIOPA proposes improving information exchange between host and home regulators, as well as playing a greater role itself in facilitating cooperation between regulators. While proposals primarily apply to supervisors, firms should view these suggestions in the context of wider proposals on enhanced reporting and disclosure requirements, particularly in relation to cross-border services in the EU.

Other proposals

Macrophotential policy

EIOPA plans to include a macroprudential perspective in Solvency II to address perceived systemic risk in insurance and proposes to grant certain additional powers to regulators to equip them to deal with systemic risk, including:

- requiring a capital surcharge, similar to a capital-add, to mitigate systemic risk posed by firms. The capital surcharge would increase the capital requirement for firms with the aim of creating an additional buffer to withstand shocks. In the consultation EIOPA invites comments from stakeholders regarding the principles that should be taken into account by regulators in their decision to trigger, set, calculate and remove capital surcharge for systemic risk
- expanding the use of the ORSA and prudent person principle to include a macroprudential perspective
- requiring firms to develop a liquidity risk management framework
- imposing a temporary freeze on redemption rights in exceptional circumstances.

Recovery and resolution

EIOPA proposes to establish a recovery and resolution (R&R) framework for insurance. The Solvency II regime could be extended to include pre-emptive requirements for firms to develop and maintain R&R plans. See our At a glance - EIOPA calls for insurance recovery and resolution framework for further discussion on this topic.

Fit and proper requirements

EIOPA found that compliance with fit and proper requirements (F&P) is not always reviewed by regulators as part of their ongoing supervisory activities. EIOPA proposes to provide clear legal powers to national supervisors to carry out ongoing F&P assessments. EIOPA has also raised the possibility of withdrawing a firm’s authorisation if senior managers and/or qualifying shareholders are not fit and proper. Under the SM&CR, UK firms already have extensive F&P requirements over a number of senior managers, and so these proposals are unlikely to result in an additional requirements for UK insurers.

What does this mean for firms?

We understand EIOPA is running a data request with regulators and firms across the continent to quantify the impact of the proposals. Even if not participating in the data exercise, this could be the right time for firms to consider the potential impact of the proposals on them and if relevant, respond to the consultation. While the future direction of the UK regime after Brexit is unclear, the Solvency II 2020 review remains a significant development for UK firms and represents an important milestone in the development of the regulatory framework for insurers and reinsurers.

Our team of experts can help you assess the impact of the proposals on your business.
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