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Revised Impact Assessment
on
the EIOPA Solvency II
Guidelines

Table of Contents

Introductory Chapter	6
Legal basement and scope	6
Definition of Baseline for Guidelines.....	6
References to legislative documents (way to properly cite).....	7
How Proportionality has been treated	7
Presentation of Impact Assessment Reports	8
Public consultation and revision	9
TITLE I – Rules on Pillar I, II and III	11
Chapter III - Rules relating to Technical Provisions.....	11
Introduction	11
1. Guidelines on Contract Boundaries	11
I - Procedural Issues and Consultation of Interested Parties	11
II - Problem Definition	11
III - Objective Pursued	12
IV - Policy Options	12
VI - Comparing the Options.....	18
2. Valuation of Technical Provisions	22
I - Procedural Issues and Consultation of Interested Parties	22
II - Problem Definition	22
III - Objective Pursued	22
IV - Policy Options	24
V- Analysis of Impact	25
VI - Comparing the Options.....	29
Chapter IV – Own Funds	30
3. Ancillary Own Funds	30
4. Classification of Own Funds	31
I - Procedural Issues and Consultation of Interested Parties	31
II - Problem Definition	31
III - Objective Pursued	32
IV - Policy Options	33
V. Analysis of Impact	34
VI - Comparing the Options.....	38
5. Ring-Fenced Funds	40
I - Procedural Issues and Consultation of interested Parties	40
II - Problem Definition	40
III - Objective Pursued	40
IV - Policy Options	41
V - Analysis of Impact	42
VI - Comparing the Options.....	45
6. Treatment of Related Undertakings including Participations	49
I - Procedural Issues and Consultation of interested Parties	49
II - Problem Definition	49
III - Objective Pursued	50
IV - Policy Options	50
VI - Comparing the Options.....	53
Chapter V – Solvency Capital Requirements	56
7. Look-Through Approach	56
I - Procedural Issues and Consultation of interested Parties	56
II - Problem Definition	56
III - Objective Pursued	57
IV - Analysis of Impact	57
VI - Comparing the Options.....	61
8. Application of Outwards Reinsurance to Arrangement to non-life Catastrophe Risk sub module	63
8.1 Order of operation of the Guidelines	63

8.2	Specification of the Events	63
	I - Procedural Issues and Consultation of Interested Parties	63
	II - Problem Definition	64
	III - Objective Pursued	64
	IV - Policy Options	64
	V - Analysis of Impact	65
	VI - Comparing the Options.....	67
8.3	Disaggregating the Gross Loss	68
	I - Procedural Issues and Consultation of Interested Parties	68
	II - Problem Definition	68
	III - Objective Pursued	68
	IV - Policy Options	68
	V - Analysis of Impact	69
	VI - Comparing the Options.....	69
8.4	Application of Outwards Reinsurance	70
	I - Procedural Issues and Consultation of Interested Parties	70
	II - Problem Definition	70
	III - Objective Pursued	70
	IV - Policy Options	70
	V - Analysis of Impact	71
	VI - Comparing the Options.....	72
8.5	Re-aggregation of Net Losses	73
	I - Procedural Issues and Consultation of Interested Parties	73
	II - Problem Definition	73
	III - Objective Pursued	73
	IV - Policy Options	74
	V - Analysis of Impact	74
	VI - Comparing the Options.....	75
8.6	Documentation and Validation	76
	I - Procedural Issues and Consultation of Interested Parties	76
	II - Problem Definition	76
	III -Objective Pursued	76
	IV -Policy Options	76
	V - Analysis of Impact	77
	VI - Comparing the Options.....	78
8.7	Particular Considerations for Solos which are Part of Groups	79
	I - Procedural Issues and Consultation of Interested Parties	79
	II - Problem Definition	79
	III - Objective Pursued	79
	IV - Policy Options	79
	V - Analysis of Impact	80
	VI - Comparing the Options.....	80
8.8	Particular Considerations for the Group Calculation.....	81
	I - Procedural Issues and Consultation of Interested Parties	81
	II - Problem Definition	81
	III - Objective Pursued	81
	IV - Policy Options	81
	V - Analysis of Impact	82
	VI - Comparing the Options.....	82
8.9	Allocation of Insurance Policies to the Liability Risk Group for the man-made Liability CAT Risk sub-module.....	83
	I - Procedural Issues and Consultation of Interested Parties	83
	II - Problem Definition	83
	III - Objective Pursued	84
	IV - Policy Options	84
	V - Analysis of Impact	84
9.	Application of the Life Underwriting Risk Module.....	87
	I - Procedural Issues and Consultation of Interested Parties	87
	II - Problem Definition	87
	III - Objective Pursued	87
	IV - Policy Options	88

V - Analysis of Impact	88
VI - Comparing the Options.....	89
10. Application of the Health Catastrophe Risk Sub-Module	90
I - Procedural Issues and Consultation of Interested Parties	90
II - Problem Definition	90
III - Objective Pursued	90
IV - Policy Options	90
V - Analysis of impacts	91
VI - Comparing the Options.....	91
11. Treatment of Market and Counterparty Risk Exposures in the Standard Formula.....	92
I - Procedural Issues and Consultation of Interested Parties	92
II - Problem Definition	92
III - Objective Pursued	92
IV - Policy Options	93
V - Analysis of Impact	93
VI - Comparison of Options	96
12. Adjustments for Loss Absorbing Capacity of TP/Deferred Taxes.....	97
I - Procedural Issues and Consultation of Interested Parties	97
II - Problem Definition	97
III - Objectives Pursued.....	98
IV - Policy Options	98
V - Analysis of Impact	100
VI - Comparing the Options.....	104
13. Basis Risk.....	106
I - Procedural Issues and Consultation of Interested Parties	106
II - Problem Definition	106
III - Objective Pursued	106
IV - Policy Options	107
V - Analysis of Impact	107
VI - Comparison of Options	108
14. Undertaking-Specific Parameters	109
I - Procedural Issues and Consultation of interested Parties	109
II - Problem Definition	109
III - Objectives Pursued.....	110
IV - Policy Options	110
V - Analysis of Impact	110
VI - Comparison of Options	114
Chapter VI – Full and Partial Internal Models	116
15. Full and Partial Internal Models	116
15.1 Validation policy.....	117
I - Procedural Issues and Consultation of Interested Parties	117
II - Problem Definition	117
III - Objective Pursued	118
IV - Policy Options	118
V - Analysis of Impact	118
VI - Comparing the Options.....	119
15.2 Validation Report	121
I - Procedural Issues and Consultation of interested Parties	121
II - Problem Definition	121
III - Objective Pursued	121
IV - Policy Options	121
V - Analysis of Impact	121
VI - Comparing the Options.....	123
15.3 Documentation User Manuals or Process Descriptions	124
I - Procedural Issues and Consultation of interested Parties	124
II - Problem Definition	124
III - Objective Pursued	124
IV - Policy Options	124
V - Analysis of Impact	124
VI - Comparing the Options.....	125

15.4	Internal model work plan for assessment and approval process of IM for groups	127
	I - Procedural Issues and Consultation of interested Parties	127
	II - Problem Definition	127
	III - Objective Pursued	127
	IV - Policy Options	127
	V - Analysis of Impact	127
	VI - Comparing the Options.....	129
15.5	Application for the Approval of Internal Models	130
15.6	Model Changes	131
15.7	Use Test	131
15.8	Assumption Setting and Expert Judgement.....	132
15.9	Probability Distribution Forecast.....	132
15.10	Methodology Consistency	132
15.11	Calibration - Approximations.....	133
15.12	Profit and Loss Attribution	133
15.13	Validation.....	133
15.14	Documentation	134
15.15	External Models and Data.....	135
15.16	Internal Models - Functioning of Colleges	136
Chapter IX – System of Governance		137
16.	System of Governance	137
	I - Procedural Issues and Consultation of Interested Parties	137
	II - Problem Definition	137
	III - Objective Pursued	138
	IV - Policy Options	138
	V - Analysis of Impact	140
	VI - Comparing the Options.....	143
17.	ORSA.....	146
	I - Procedural Issues and Consultation of Interested Parties	146
	II - Problem Definition	147
	III - Objective Pursued	148
	IV - Policy Options	149
	V - Analysis of Impact	149
	VI - Comparing the Options.....	152
Supervisory Review Process.....		156
18.	Supervisory Review Process.....	156
	I - Procedure Issue and Consultation on Interested Parties	156
	II - Problem Definition.....	157
	III - Objective Pursued	158
	IV - Policy Options	159
	V - Analysis of Impact	160
	VI - Comparison of Options	172
TITLE II – Insurance Groups		175
Chapter I – Group Solvency		175
19.	Group Solvency Calculation	175
	I - Procedural Issues and Consultation of interested Parties	175
	II - Problem Definition.....	175
	III - Objectives Pursued.....	176
	IV - Policy Options	177
	V - Analysis of Impact	178
	VI - Comparing the Options.....	184
TITLE III – Third Country Equivalence		185
20.	Third Country Equivalence.....	185
	I - Procedural Issues and Consultation of Interested Parties	185
	II - Problem Definition	185
	III - Objectives Pursued.....	186
	IV - Policy Options	187
	V - Analysis of Impact	187
	VI - Comparing the Options.....	192

Introductory Chapter

Legal basement and scope

- 0.1 According to Article 16 of Regulation (EU) No 1094/2010 (EIOPA Regulation), EIOPA shall, where appropriate, analyse the potential costs and benefits of guidelines addressed to National Competent Authorities (NCAs) or financial institutions. The analysis of costs and benefits is undertaken according to an Impact Assessment methodology.
- 0.2 This document contains the Impact Assessment (IA) for the Set 1 of EIOPA Guidelines on Solvency II, which includes:
- Contract boundaries;
 - Valuation of technical provisions;
 - Ancillary Own Funds;
 - Classification of own funds;
 - Ring-fenced funds;
 - Treatment of related undertakings, including participations;
 - Look-through approach;
 - Application of outwards reinsurance arrangements to the non-life underwriting risk sub-module;
 - Application of the life underwriting risk module;
 - Application of the health catastrophe risk sub-module;
 - Treatment of market and counterparty risk exposure in the standard formula;
 - Loss absorbing capacity of technical provisions and deferred taxes.
 - Basis Risk;
 - Undertaking-specific-parameters;
 - Internal models, including the functioning of colleges for internal models;
 - System of governance and ORSA;
 - Supervisory review process;
 - Group solvency calculation;
 - Methodology for equivalence assessment of national supervisory authorities under Solvency II.

Definition of Baseline for Guidelines

- 0.3 When analysing the impact from proposed policies, the Impact Assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention
- 0.4 The baseline for this Impact Assessment Report is based on the current situation of EU insurance and reinsurance markets, taking account of the progress towards the implementation of the Solvency II framework achieved at this stage by insurance and reinsurance undertakings and supervisory authorities.
- 0.5 In particular the baseline will include:
- The relevant content of Directive 2009/138/EC, as amended by Directive 2014/51/EU;
 - The relevant Implementing Measures.

References to legislative documents (way to properly cite)

0.6 For clarity purposes, the legal documents referred to in the Guidelines as well as in this Report correspond to the following:

- Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority is referred to as "EIOPA Regulation";
- Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance is referred to as "Solvency II" or "the Directive";
- The Implementing Measures of Solvency II, as published by the European Commission on 10 October 2014, are referred to as such ("Implementing Measures")¹;
- Technical Standards can be referred to as "ITS" (for Implementing Technical Standards) or "RTS" (for Regulatory Technical Standards);
- The abbreviations used in this Report should correspond to the abbreviations of the corresponding Guidelines, which also correspond to the ones used in the legal acts of reference.

How Proportionality has been treated

0.7 Solvency II stipulates that its provisions should be applied in a manner that is proportionate to the nature, scale and complexity of the business of insurance and reinsurance undertakings. In doing so, EIOPA has considered if more specific or additional criteria to nature, scale and complexity are appropriate within a particular context to ensure a proportionate application of the guidelines. EIOPA has also considered where it may be appropriate to differentiate the treatment of smaller insurance undertakings.

0.8 Nevertheless, in particular within the context of the Guidelines, it is important to underline that:

- The principle of proportionality applies even where not explicitly mentioned: the application of the guidelines by supervisors and undertakings must be carried out in a proportionate way at all times;
- The application of the proportionality principle should not be equated with a reduction or disapplication of the guidelines. The application of the principle can equally demand that more stringent or detailed approaches are necessary with regard to particular risks or complexities.

0.9 The proportionality analysis is undertaken in the framework of the policy development process and as part of the impact assessment, where the expected impact on the relevant stakeholders for the proposed policy is analysed.

0.10 Generally, in the development of the Guidelines and the analysis of their related potential costs and benefits, proportionality is implicit in the processes and therefore specific considerations have been included only where an explicit

¹ http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/delegated/141010-delegated-act-solvency-2_en.pdf

clarification or assessment is relevant. Therefore, the proportionality lies mostly in the nature and complexity of the particular element at hand.

Presentation of Impact Assessment Reports

0.11 This comprehensive Report assembles together all Impact Assessments for the Solvency II Guidelines comprised in the first wave.

0.12 The sequence with which Impact Assessments are presented mirrors the sequence of the same issues in the Implementing Measures. This choice has been selected for a twofold goal: in order to favour a joint reading of EIOPA Guidelines and the Implementing Measures on top of which Guidelines have been conceived; and to group IAs by main theme, so keeping close to each other IA that refer to the same issue or to interconnected issues.

0.13 Furthermore, there is another more operational reason for ordering according to the Implementing Measures. This ordering gives the possibility to split the full comprehensive IA Report into different parts (e.g. Pillar I, II, III) without losing readability and completeness.

0.14 All IAs follow a common structure based on six sections:

1. Procedural Issues and Consultation of Interested Parties;
2. Problem Definition;
3. Objective Pursued;
4. Policy Options;
5. Analysis of Impact;
6. Comparison of Options.

0.15 Sometimes a seventh section can be added, Monitoring and Evaluation, but only where specific details have been discussed and adopted regarding the monitoring of the phasing-in of Guidelines and the evaluation of objectives realization.

0.16 Around this common structure, Impact Assessment reports can slightly differ in some formal aspect and sometimes also in the allocation of contents across chapters. For example, there are few cases in which, being only one (or a couple) the policy option(s) alternative to the baseline, section 4 and section 5 have been substantially merged, with the description of the policy option that offers at the same time the analysis of impact.

0.17 More often Impact Assessment reports differ in the substructure of sections: in some cases there is no substructure, and sections consist of a continuous narrative; in other cases sections are divided into paragraphs and also subparagraphs; in other cases, there is not a real substructure, but bold words or underlined phrases are used to organise the narrative and strengthen the logics of the text.

- 0.18 Another difference regards the description of the baseline. At the beginning of the IA Report an ad-hoc paragraph is dedicated to provide a clear and incontrovertible description of the baseline that, by definition, is valid for all the IAs. Nevertheless, there are also Impact Assessment reports that contain a repetition of the description of the baselines that was worth to be retained because helping the reading and already part of a fluid and well written narrative.
- 0.19 Another difference that is worth mentioning regards the use of the terms “policy options” and “policy issues”. The general rule is that the issue represents the broad theme at stake, which involves one or more problems that can be overcome thanks to different alternative policy options. Normally, policy issues are described under “Problem Definition”, while policy options are listed under “Policy Options”. Nevertheless, in cases where there is only one alternative policy option, the description of the issue at stake can be presented in a way that becomes integrated with the description of the policy option. In this cases, the aim was to try to preserve at most the narrative elaborated by working group, provided the correctness of contents and the uniqueness of interpretation.
- 0.20 Another recurrent difference regards the breakdown of effects by actors (undertakings, supervisory authorities, policy holders). The vast majority of papers include this breakdown even when there is no effect to report (as an explicit confirmation of the absence of effects). On the contrary, some others focus only on really existing and detected effects with the aim of shortening the narrative and not becoming dispersive. To the extent this choice was not detrimental for the clarity and the completeness of the analysis, EIOPA position was to allow a certain degree of flexibility.
- 0.21 It is worth mentioning that in some guidelines, tables and graphics have been inserted in order to sum-up and clarify the narrative. Nevertheless, the standard is that tables and graphics cannot substitute the narrative. For example, where the number of options is material or with complex interrelations, the section “Analysis of Impact” may be clearer if the “Comparison of Options” is developed with a succinct narrative accompanied by summing-up tables. On the contrary, those areas with more straightforward issues and options may explain in a more narrative manner the rationale underlying the selection of options.

Public consultation and revision

- 0.22 According to Article 16 (2) of the EIOPA Regulation, EIOPA carried out public consultation on the Set 1 of Guidelines on Solvency II, including their Impact Assessment, from 2 June to 29 August 2014.
- 0.23 The Set 1 of EIOPA Guidelines on Solvency II, were subject to public consultation under the following consultation papers:
- Consultation Paper on Pillar 1 GL, including Guidelines on Technical Provisions, Own Funds, the Standard Formula SCR and Group Solvency;
 - Consultation Paper on Internal models GL;
 - Consultation Paper on Pillar 2 GL, including ORSA and Governance;
 - Consultation Paper on Supervisory Review Process (SRP) GL;
 - Consultation Paper on Equivalence GL.

- 0.24 A separate Consultation Paper was prepared for the Impact assessment.
- 0.25 No comments were received from the stakeholders on the specific content of the IA. However the IA has been revised according to any changes agreed on the revised guidelines, taking into account the results of the public consultation.
- 0.26 EIOPA has issued Final Reports containing the Set 1 of EIOPA Guidelines on Solvency II. The Final Reports are available in EIOPA's website. The comments received during the public consultation and EIOPA's responses to them are summarised in the section Feedback Statement of the Final Reports.

TITLE I – Rules on Pillar I, II and III

Chapter III - Rules relating to Technical Provisions²

Introduction

This Section counts two IA reports on Technical Provisions: the first one relates to Contract Boundaries, while the second to the all other kinds of Technical Provisions.

1. Guidelines on Contract Boundaries

I - Procedural Issues and Consultation of Interested Parties

- 1.1. The Guidelines were prepared in the course of the process to draft ITS on Contract Boundaries which were later redrafted into guidelines. The Impact Assessment incorporates feedbacks received from an EIOPA pre-consultation exercise.
- 1.2. Because contract boundaries define the relevant cash flows to be taken into account in calculation of technical provisions, proportionality principle can't be used when applying contract boundary provisions, but it is relevant when calculating technical provisions. However, EIOPA has in Guideline 11 considered that estimation of certain obligations is in some cases temporarily possible.
- 1.3. Most guidelines are just clarifications of the Implementing Measures.

II - Problem Definition

General

- 1.4. Articles 17 and 18 of the Implementing Measures define the contract boundaries. If the principles of contract boundaries would not be converged between insurance undertakings, insurance undertakings could apply different contract boundaries to same type of contracts. Also the undertakings could choose the contract boundaries that suit their strategies best and not the ones that assure adequate solvency.
- 1.5. Even the supervisors could interpret the provisions differently. If there would be floor to different interpretations, this could result that cross-border insurance groups should use different contract boundaries for the same products.
- 1.6. In general, different interpretations of contract boundaries would impair the reliability and comparability of the technical provisions.
- 1.7. The current Guidelines on Contract Boundaries are addressed to insurance and reinsurance undertakings when calculating the technical provisions under Solvency II regime.
- 1.8. For this purpose the Guidelines cover the definition of the relevant terms as well as they provide guidance for the understanding and application of the

² Following the order of the Implementing Measures.

Implementing Measures, i.e. unilateral right, ability to compel, full reflection of risks. The Guidelines also set guidance on unbundling of contracts, what should be considered as discernible effects for the economics of a contract, how obligations should be estimated in some cases and how reinsurance contracts are treated.

- 1.9. As a result, there is need to give more detailed guidance on contract boundaries.

Baseline

- 1.10. When analysing the impact from proposed policies, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve if the guidelines would not be applied.
- 1.11. For the analysis of the potential related costs and benefits of the proposed Guidelines, EIOPA has applied as a baseline scenario the one described in the Introduction.

III - Objective Pursued

- 1.12. The aim of these Guidelines is to increase convergence within the Member States and between the insurance undertakings.
- 1.13. With these Guidelines EIOPA aims to promote an effective application of the regulation to calculate the technical provisions. The Guidelines clarify what cash flows are taken into account when calculating technical provisions.

IV - Policy Options

- 1.14. With the intention to meet the objectives set out in the previous section, EIOPA has analysed different policy options throughout the policy development process. Proposed Guideline 1 is not expected to have material impact compared to the baseline, however it is proposed for the purpose of clarification and achievement of common understanding.
- 1.15. The section below reflects the most relevant policy options that have been considered when determining the methods to define the contract boundaries. We have also listed relevant options which have been discarded in the policy development process.

Policy Issue 1: Accuracy of Guidance

Policy Option 1:

- 1.16. The proposed Guidelines are principle based, but some examples are attached to the explanatory text. However, even the presented examples are of general nature in order to be able to apply them in several circumstances (principle based option).

Policy Option 2:

- 1.17. One option would have been that the Guidelines would be rule based and that the Guidelines would give fixed examples (fixed example option).

Policy Issue 2: Consistency of Principles

Policy Option 1:

- 1.18. Consistency over time results that the principles of contract boundaries once defined do not change unless the contract itself has been amended (stability option).

Policy Option 2:

- 1.19. One option would have been that no consistency requirements regarding contract boundaries are needed (volatility option).

Policy Issue 3: Unilateral Right

Policy Option 1:

- 1.20. To define the parties which are involved in the application of unilateral right (option to define the parties).

Policy Option 2:

- 1.21. Regarding point a) of Guideline 2, external parties are not relevant when considering restriction of the right unless they truly represent the policyholders – e.g. are elected by them (true representation option).

Policy Option 3:

- 1.22. Regarding point d) of Guideline 3, the decisions made by policyholder or the beneficiary affects the contract boundaries (policyholder decision option).
- 1.23. This is e.g. a case when the policyholder reallocates the investments of a unit-linked policy and the charges of the funds are fund-specific. The same applies also e.g. flexible payment plans that are common in new life insurance products.

Policy Option 4:

- 1.24. To regulate how Policyholder Reasonable Expectations affect the unilateral right (Policyholder Reasonable Expectations option).

Policy Issue 4: Full Reflection of the Risk

Policy Option 1:

- 1.25. To assess the full reflection of the risk by expected present values of premiums, benefits and expenses (expected present value option).

Policy Option 2:

- 1.26. To regulate the treatment of future management actions and discounts in the present policy proposal (future management action option).

Policy Issue 5: Unbundling of the Contract

Policy Option 1:

- 1.27. In case a contract would be unbundled, to set qualitative requirement for cases on unbundling (qualitative requirements option).

Policy Option 2:

- 1.28. Not to set qualitative requirements on when the separation of premiums and benefits is possible (no qualitative requirements option).

Policy Option 3:

- 1.29. To consider that unbundling should be made whenever it is possible to unbundle two sets of obligations (obligatory unbundling option).

Policy Option 4:

- 1.30. To make unbundling regardless that the discernible effect on the economics of the contract is visible in only one set of the obligations (separation of discernible effects option).

Policy option 5:

- 1.31. To give criteria how to evaluate the possibility to unbundle a contract (evaluation criteria option).
- 1.32. Regarding obligatory unbundling option, it was noted that article 18 (6) of the Implementing Measures article does not require to unbundle two sets of obligations whenever it is possible.

Policy Issue 6: Identification of a Discernible Effect on the Economics of a Contract

Policy Option 1:

- 1.33. To define discernible effect as discernible financial advantage with commercial substance (no materiality option).

Policy Option 2:

- 1.34. To include a requirement about materiality on the effect (materiality option).

Policy Option 3:

- 1.35. To require that the effect on the economics of the contract should always mean positive cash flow for the policy holder or beneficiary; i.e. a link between payments and claims (positive effect option).

Policy Option 4:

- 1.36. To determine fixed limits within which the effect is not considered to be discernible (fixed limits option).

Policy Issue 7: Estimation of Obligations

Policy Option 1:

- 1.37. To estimate the obligations when exact data is not available to perform accurate calculations at the inception of the contract (estimation option).

Policy Option 2:

- 1.38. To use the proportionality principle if the impact of not estimating the contract boundaries would not be material and the contract boundaries are determined when more granular data are available (no estimation option).

Policy Issue 8: Reinsurance Contracts

Policy Option 1:

- 1.39. Not to introduce a requirement that the reinsurance undertakings should take into account the contract boundaries of the underlying contracts (no dependence option).

Policy Option 2:

- 1.40. To take into account the contract boundaries of the underlying contract (dependence option).

Policy Option 3:

- 1.41. To regulate also the intra-group transactions in these Guidelines (intra-group option).

V - Analysis of Impact

- 1.42. The impacts can be positive or negative from insurance undertaking point of view depending on the products, duration of the policies and premium structures.

- 1.43. Because the Guidelines are principle based, it is still possible that undertakings interpret the principles differently.

- 1.44. In most cases the Guidelines just clarify the draft Implementing Measure text.

- 1.45. The Guidelines give guidance about what cash flows are taken into account when calculating technical provisions. There are three possible outcomes:
 - the cash flows in the beginning of the contract period are clarified,
 - the cash flows at the end of the contract period are clarified,
 - cash flows of different parts of the contract are treated differently.

- 1.46. In addition to this, Guideline 8 clarifies the treatment of reinsurance undertakings.
- 1.47. Guideline 7 deals with the cash flows in the beginning of the contract. Guideline 5 deals with the separation of cash flows, that is unbundling. All the other Guidelines deal with the cash flows at the end of the contract period.
- 1.48. If the unilateral right does not exist (e.g. in Guideline 2 a), some Guidelines are not applied to the contract.
- 1.49. In principle, in most cases there are two possible alternative contract boundaries. The Guidelines clarify which contract boundary is chosen and how. The impact of the Guidelines depends on which of the two alternatives have been chosen.
- 1.50. Because the Guidelines mostly just clarify the Implementing Measures text and the Guidelines are new, the Guidelines do not have material impacts compared to the baseline. However, when comparing two alternative contract boundaries as described above, the Guidelines may have material impacts. Different Guidelines may result into the same contract boundary. In order to avoid repetition of the text, the impacts have not been described option by option.

The impacts have been described below:

Impacts on insurance undertakings

- 1.51. One of the main impacts is that the convergence within the Member States and within the insurance undertaking is increased. By taking into account the future premiums and related obligations, the economic value of the undertaking is also better measured.
- 1.52. Contract boundaries themselves have great impact on the technical provisions. However, the impact is mostly direct cause of Implementing Measures.
- 1.53. If the assumptions used in technical provisions turn out to be too optimistic and the future premiums and related obligations are taken into account, this may lead to too low technical provisions. The same applies if the future premiums and related obligations are not taken into account and there exist risks and policyholder options covered by future premiums.
- 1.54. If all future premiums and cash flows related to new premiums are known, all future premiums and related obligations could be taken into account and the policyholder behaviour in accordance with article 26 of the Implementing Measures. Especially when the undertaking decides to amend the premiums or benefits, it is not possible to anticipate the policyholder behaviour and it is reasonable not to consider all future premiums and related obligations. This is also the case with products that have been taken in investment purposes rather than to cover risks.

- 1.55. It is not possible to anticipate the effects of contract boundaries themselves because the impacts depend on the products (that are often market-specific), duration of the policies and premium structures. For example, if the policyholder has a right to pay new premiums:
- In case of a savings contract with a 4,5 % guaranteed interest, the future premiums under current interest rate environment mostly increase the technical provisions;
 - In case of a unit-linked contract, the future premiums mostly decrease the technical provisions if the contract is properly tariffed;
 - In case of lifetime pension, the impact depends how well the future development of longevity risk has been captured;
 - In case of a risk insurance, the impact depends on what are the future claim expenses. If the contract is older and the expense assumptions have turned out to be insufficient, it is already known that taking into account the future premiums would increase the technical provisions.
- 1.56. In one member state it was analysed what would be the impacts on the company with and without taking into account the future premiums and related obligations. The study was made with contracts where the death benefit is equal to 100% of the savings amount. Depending on the product, taking into account the future premiums had a positive impact on the expected profits in future premiums between 0.42% and 3.10%. So, the duration of the contracts affects the impact. In some other markets and in case of other products the impact could be both lower and higher but it is relevant.
- 1.57. Compared to contract boundaries applied in different quantitative impact studies some undertakings may face need to amend their contract boundaries due to more accurate regulation of contract boundaries which may affect technical provisions.
- 1.58. Guideline 7 that describes the estimation of obligations in certain cases may cause additional costs, but the costs are limited to implementation of solvency II. Also unbundling itself may increase implementation costs, but compared to the baseline, no additional costs are expected. In general, it is not expected that the Guidelines would increase costs compared to the baseline.

Impacts on policyholders and beneficiaries

- 1.59. Properly calculated provisions increase the policyholder protection by assuring adequate solvency.
- 1.60. If the contract boundaries result in higher solvency requirements as described above, it is possible that the undertakings take this into account in pricing. This may affect also on the discretionary benefits.
- 1.61. It is possible that some undertakings will streamline their businesses and products so that the contract boundaries yield to lower capital requirements. As a result, this may affect the product portfolios and also standardise the product supplies between insurance undertakings.

Impacts on supervisors

1.62. No direct costs to supervisors are expected. However, if the principles would not be converged and the contract boundaries would differ from one member state to another, that would make the cross-border supervision more difficult.

Impacts on company/consumer behaviour

1.63. No impact on company/consumer behaviour is expected.

VI - Comparing the Options

1.64. The aim of the Guidelines is to increase convergence within the Member States and between the insurance undertakings. All options, both the main options and the alternative options fulfil this target. Decision on whether an issue needs clarification or not has been made by analysing alternatives of the provisions of Articles 17 and 18 of the Implementing Measures. Also the decisions what options have been chosen have mostly been made on the same basis. It has been mostly assumed that Implementing Measures as a baseline has taken into account the points mentioned in the problem identification as described in section III.

1.65. Most of the impacts of the alternative options have already been described in the section IV because the alternative option is the other one of the two possible contract boundaries.

Policy Issue 1: Accuracy of guidance

1.66. Regarding fixed example option, due to variety of insurance products and several taxation, accounting and regulatory regimes it was not possible to give fixed rules and present detailed example list that would suit for all markets. So, the principle based approach was chosen and the convergence means the convergence of the principles.

Policy Issue 2: Consistency of the Principles

1.67. Regarding the volatility option, if the provisions would change artificially from one calculation to another, this would increase remarkably the need of analysis resources of both the undertaking and the supervision and the calculation would not be such transparent anymore and the cash flows within years comparable.

1.68. However, the renewable policies should have a contract boundary in the future and thus get a new contract boundary when renewed and the long-term policies should get a new contract boundary only when the characteristics of the policy or the policy itself change. So, consistency over time has been chosen.

Policy Issue 3: Unilateral Right

1.69. "Unilateral right" is a legal term, but without the Guideline it would be unclear which are the parties taken into account. So, the option to define the parties has been chosen.

- 1.70. It has been especially mentioned that the supervisory authorities are not among those parties, because the supervisory authorities have special powers in crisis situations.
- 1.71. Because the Implementing Measures does not clarify the parties involved, there is need to distinguish e.g. circumstances where the external parties restrict the unilateral right of the undertaking from circumstances where the external parties may actually be considered to be part of the management body and so do not restrict the unilateral right. At least in Germany and France there are arrangements where there are external bodies. Governance bodies of insurance and reinsurance undertakings have been specifically excluded in order to be sure that e.g. a general assembly of a mutual insurance company would be excluded. The concept "governance body" has been clarified separately.
- 1.72. Regarding true representation option, the opinion is that the external parties would be relevant when considering the unilateral right.
- 1.73. Regarding policyholder decision option, there is no need to take into account the decisions made by the policyholder because this does not affect the likelihood of lapses and there is no need to set a contract boundary. So, this is a good basis for reliable technical provisions which is one of the aims of the Guidelines.
- 1.74. Regarding Policyholder Reasonable Expectations option, Policyholder Reasonable Expectations have not been handled because the concept is not widely used within EU and there are several interpretations of the concept. So, it was not possible to give a clarification that suits for all cases.

Policy Issue 4: Full Reflection of the Risk

- 1.75. Regarding expected present value option it was considered that there is no need to calculate policy by policy the present value of the premiums payable or benefits and expenses payable but an overall assessment on portfolio level is enough. The term "expected present value" impedes also the elements that should be taken into account in the assessment.
- 1.76. Even a premium does not need to be certain in its timing or amount to belong to the contract. This is also a consequence of Guideline 2 (d) of this Guideline.
- 1.77. Regarding future management actions option, also treatment of future management actions and discounts were discussed and a note to explanatory text was added.

Policy Issue 5: Unbundling of the Contract

- 1.78. Regarding no qualitative requirements option, if qualitative requirements would not be set on the separated premiums and benefits, this would give rise to potential for inconsistency in the way an eventual unbundling is applied and the targets of these Guidelines would not be fulfilled.
- 1.79. Because in theory all savings products could be unbundled in the way that the discernible effect is visible in only one set of obligations, regarding separation of discernible effects option Article 18 (5) of the Implementing Measures would become null and the option is not reasonable.
- 1.80. Regarding evaluation criteria option, it was noted that by given fixed criteria how to evaluate the possibility to unbundle a contract might restrict the cases where there would be no requirement to unbundle.

Policy Issue 6: Identification of a Discernible Effect on the Economics of a Contract and Discernible Effect of the Coverage of an Event

- 1.81. Regarding materiality option, it was noted that discernible means recognizable and materiality can't be required. So, it is required that there is a discernible financial advantage with commercial substance. It is evident that discernible means that the effect should be reasonably seen. This is mentioned in the explanatory notes. This is just an interpretation of the word "discernible" but important from convergence point of view.
- 1.82. Regarding positive effect option, it was noted that the effect on the economics of the contract should not always mean positive cash flow for the policy holder or beneficiary and such a requirement was not set. It is even mentioned in the explanatory text that a guarantee that a policy holder does not lose at least part of savings shall be considered as a financial guarantee. This was commented by stakeholders, too. Positive effect option would have resulted that quite many products would have been considered such that future premiums and related obligations can't be taken into account. The chosen option does not reduce the convergence.
- 1.83. Because the products vary a lot from one market to another, regarding fixed limits option, it was not possible to give fixed limits within which the effect is not considered to be discernible. It was also discussed if such an example would be incorporated into the list of examples. However, because all other examples in the list are principle based, it was decided not to give a fixed example which is in line with the treatment of fixed example option described above.

Policy Issue 7: Estimation of Obligations

- 1.84. Regarding no estimation option, it was considered that the Implementing Measures do not give floor to such an interpretation that the contract boundaries are determined when more granular data are available. However, proportionality principle can be taken into account when calculating technical provisions which reduces administrative costs for undertakings. The chosen option increases convergence in a proportionate way.

Policy Issue 8: Reinsurance Contracts

- 1.85. Regarding dependence option, if the contract boundaries of the underlying contract would have been taken into account, this would cause huge amount of data exchange between the undertakings and is not effective and the option was not chosen. The option did not even seem to be in line with the Implementing Measures text. The chosen option also increases convergence.
- 1.86. Regarding intra-group option, a decision was also that the Guidelines do not cover intra-group transactions but concentrates on solo-undertakings.

VII - Monitoring and Evaluation

- 1.87. The monetary impacts are immediate impacts after the implementation of Solvency II and will not be evaluated afterwards.
- 1.88. If in course of peer reviews EIOPA finds out that similar products with similar terms and conditions are treated differently within Member States or undertakings, this may result in need to amend either these Guidelines or the Implementing Measures text.

2. Valuation of Technical Provisions

I - Procedural Issues and Consultation of Interested Parties

- 2.1. The objectives of the Guidelines on valuation of technical provisions are to increase consistency and convergence of professional practices for all types and sizes of undertakings across Member States and support undertakings in their calculation of technical provisions under Directive 2009/138/EC. The guidelines will be on the first hand applied both by actuaries and by other people who will be appointed to carry out the tasks of the actuarial function.
- 2.2. In order to analyse the impacts of technical standards, guidelines and recommendations, EIOPA will analyse the potential related costs and benefits in accordance with articles 10, 15 and 16 of the EIOPA Regulation. Thus EIOPA shall, where appropriate, conduct open public consultations regarding the guidelines and recommendations and analyse the related potential costs and benefits. Such consultations and analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations. EIOPA shall, where appropriate, also request opinions or advice from the relevant stakeholder groups in accordance with Article 37 of EIOPA Regulation.
- 2.3. The Impact Assessment incorporates feedback received from an EIOPA pre-consultation exercise. The pre-consultation was carried out at an earlier stage of the process.
- 2.4. A public consultation of the Guidelines and its impact assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' comments were duly taken into account and served as a valuable input in order to revise the Guidelines.

II - Problem Definition

- 2.5. The European Commission has defined the rules for the calculation of technical provisions in Articles 17 to 61 of Implementing Measures. The mandate therefore has been given by the Article 86 of Solvency II. The Implementing Measures provide mostly principles for the calculation of technical provisions and some documentation requirements. Hence, it was considered to be important to provide some guidelines which shall ensure a harmonised calculation of technical provisions.
- 2.6. To measure the additional effects created by these Guidelines, EIOPA used the baseline described in the Introduction. With respect to this baseline, EIOPA analysed which topics may be resolved/enhanced by the introduction of new Guidelines. These Guidelines should assure a common interpretation of the provisions defined in the baseline.

III - Objective Pursued

The underlying objectives of the entire set of guidelines are:

Need for harmonised implementation of processes to comply with the requirements in Solvency II

- 2.7. It seems necessary to adapt certain processes within undertakings to comply with the requirements in Solvency II for the calculation of technical provisions. Processes are necessary in order to assure adequate assumptions, classifications in homogenous risk groups, segregations of contracts and methods for the calculation of technical provisions. Processes of permanent reviews are important in order to reflect changes in contract designs and risk structures.
- 2.8. For the implementation of such processes undertakings should be able to apply first and foremost the overarching principle of proportionality. The principle means that when applying proportionality principle, undertakings should use methods for the calculation of technical provisions which are proportionate to the nature, scale and complexity of the risks inherent in the business of insurance or reinsurance undertaking (the Directive, Article 29). Furthermore there are strong interrelations between different aspects of technical provisions calculations which are mostly not covered by the implementing measures. In particular, there is a strong interrelation between the choice of homogenous risk groups, data quality and the calculation methods which strongly affect the quality of results.
- 2.9. The Implementing Measures allow some discretion for the NCA's when interpreting the abovementioned processes, which bears some legal risks for undertakings. This could interfere with cross-border business and therefore with the single European market. Furthermore, it is important that NCA's achieve an appropriate implementation of processes in order to prevent risks related to insufficient calculation of technical provisions.

Need for harmonised approach of common actuarial techniques in the context of solvency II

- 2.10. The intention of the Implementing Measures is not to describe exact acceptable or not-acceptable methods for the valuation of technical provisions. But certainly there is a wide range of techniques and methods commonly used by actuaries for the calculation of technical provisions in Solvency I or other regimes that the undertakings would like to transfer into the Solvency II framework. This may require that undertakings adapt those methods to comply with the principles defined in the implementing measures.
- 2.11. The Implementing Measures do not provide a common framework for such methods which would not allow for an optimal level of harmonisation. Furthermore there is a high degree of legal risks for undertakings in regard to the approval of certain methods. This could lead to increased costs for undertakings which the undertakings may transfer to policyholders. Furthermore, without harmonisation the quality of technical provisions calculation could be insufficient.

Need for simplified calculation of technical provisions within the year

- 2.12. According to Article 129(4) of the Solvency II, the MCR needs to be calculated on a quarterly base. This necessitates a quarterly calculation of technical provisions to derive the input values for the calculation of the MCR and to derive the OF. The calculation of technical provisions between the annual reporting dates may give rise to additional practicability issues. For example, the databases and processes of the undertaking may not be adequate for this task as data is often collected on an annual basis. There are calculations which

are so time-consuming and resource intensive that requirement to repeat them fully during the year may not be proportionate in relation to the supervisory needs. Therefore, simplifications and approximations compared to the calculation of technical provisions at year end may be necessary.

- 2.13. There is thus a need to define further principles for the quarterly calculation of technical provisions to achieve optimal convergence.

Need of guidance in the Use of Data Improvements and Estimations

- 2.14. Data management is of high importance to allow for a reliable calculation of technical provisions. Therefore it is important that undertakings recognise data deficiencies and consider data approximations. To make a reliable analysis of data, use of expert judgement could be necessary.

- 2.15. The abovementioned concepts could be applied very differently and in some cases expert judgement could be applied inappropriately. There is risk that appropriate data management is not present. This could lead to an inappropriate calculation of technical provisions.

- 2.16. There is thus a need to provide some guidance in the use of data improvements and estimation.

IV - Policy Options

Harmonised implementation of processes to comply with the requirements in Solvency II (corresponding to the I Objective)

- 2.17. Policy Option 1 – Definition of assessments to ensure compliance with the Solvency II requirements. This option outlines processes to be followed in the calculation of technical provisions so that compliance with the requirements in implementing measures is assured. For example, different checks of the valuation of options and guarantees, EPIFP and segmentation are defined. The goal is to assure that the most important processes are implemented consistently across all European undertakings and to assure that the materiality and proportionality principles are applied homogeneously.

- 2.18. Policy Option 2 – Prescription of standard methods and/or thresholds. This option is similar to Option 1, supplemented by methods defined by EIOPA. Those methods would have to be used in the calculation of TP. An implementation of specific proportionality and materiality thresholds could also be defined in certain cases for the chosen methods.

Harmonised approach of common actuarial techniques in the context of solvency II (corresponding to the II Objective)

- 2.19. Policy Option 1 - Definition of requirements for the use of common actuarial practices. This option deals with techniques which are typically used by actuaries. The following concepts, among others, should be considered within these guidelines:
- Economic Scenario Generators;
 - Replicating Portfolio Techniques for Valuation;
 - Chain Ladder Methods.

- 2.20. In this option these concepts will be described in specific guidelines and collated with the requirements of the Implementing Measures. In this option the intention is to provide and define further principles and requirements in the cases when specific actuarial techniques can be considered to be compliant with Solvency II. One method is to define different checks and conditions for the choice of parameters and appropriate tests. In order to enable that more actuarial practices might be considered to be consistent under Solvency II, closed lists should be avoided.
- 2.21. Policy Option 2 – Definition of standard methods. The Option 1 is supplemented by the definition of standard methods by EIOPA. If undertakings don't make use of standard methods, undertakings should justify non-use of standard methods.

Simplified calculation of technical provisions within the year (corresponding to the III Objective)

- 2.22. Policy Option 1: The only option foreseen in this case is: Allowance for simplified calculation of technical provisions within the year and defining the requirements. In this policy option it is in general allowed to use a simplified calculation of technical provisions. Simplified means in this context that the method is simplified when compared to the calculation of technical provisions at year end. Undertakings are also asked to change assumptions when external circumstances change materially. Furthermore applicable methods are introduced. A sensitivity analysis could be required for life undertakings.

Guidance in the Use of Data Improvements and Estimations (corresponding to the VI Objective)

- 2.23. Policy Option 1: The only option foreseen in this case is: Definition of further guidelines to allow for harmonised data handling and harmonised approach of data management. In this option undertakings are required to strongly consider the interaction between data quality and the quality of the technical provisions. In this option typical concepts like data adjustments and expert judgement are allowed, under certain conditions. Also use of approximations is allowed.

V- Analysis of Impact

- 2.24. The selected options are now analysed in regard to their expected impacts. A more detailed analysis will be done for the chosen options in regard to predefined stakeholder groups:
- Policyholders;
 - Undertakings;
 - NSAs and EIOPA;
 - Financial Stability.
- 2.25. No direct social impact is to be expected from those guidelines, therefore it is not analysed further.

Harmonised implementation of processes to comply with the requirements in Solvency II (corresponding to the I Objective)

- 2.26. Supervision and in particular supervision of undertakings which pursue cross border business and insurance groups could be facilitated if there would exist a

harmonised approach of processes within undertakings across Europe. Policyholder protection would be increased, because a higher level of security could be guaranteed with an appropriate calculation of technical provisions. This would be achieved both by Option 1 and 2.

- 2.27. The compliance costs of Option 1 are in certain cases higher, because some processes may currently be differently implemented in undertakings and undertakings would have to adapt their processes. However, sometimes also the compliance costs of Option 2 can be higher if cross-border undertakings apply different valuation principles in different countries. The baseline does not describe predefined processes, which undertakings have to follow. Therefore in Option 2 undertakings would have to make some efforts to verify whether the undertaking complies with the principles or not.
- 2.28. In some cases the baseline might lead to solutions where the proportionality principle has been used when it is not applicable. Therefore in Option 1 it has to be assured that the proportionality principle has been followed. Regarding Option 2, it seems impossible to implement thresholds and methods which are proportionate for every undertaking.
- 2.29. Furthermore Option 2 is impossible to implement from a legal perspective, because the goal of defining guidelines is only to assure the harmonised application of the provisions in the Implementing Measures, not to overwrite them.
- 2.30. After having compared the costs and benefits, Option 1 has been chosen.
- 2.31. Impacts of Option 1 on policyholders. To define processes for insurance undertakings will as a whole have a positive effect on policyholders. It will enable better implementation of cross-border business and the policyholder protection is increased. On the other hand, there is in some cases a pressure to increase premiums due to the increased implementation costs of the undertakings.
- 2.32. Impacts of Option 1 on undertakings. The regulation could avoid that some undertakings would try to reduce their costs by implementing processes inappropriately. Legal risks of undertakings are avoided when a common understanding of processes exists. A common understanding of processes could facilitate cross-border business and avoid solvency arbitrage. On the other hand, there is a risk that some undertakings need to implement processes which do not fit to their businesses. It seems that the aforementioned risk can be avoided in the policy making process and the benefits outweigh the costs.
- 2.33. Impacts of Option 1 on NSAs. If the undertakings have implemented their processes similarly, this may reduce costs for NSA's because the supervision practices could be unified. Therefore the chosen option is clearly a benefit for supervisors.
- 2.34. Impact of Option 1 on financial stability. This option has a positive contribution to financial stability, because it ensures a prospective and risk sensitive supervision. It is also expected that a more stable valuation of technical provisions will be achieved.

Harmonised approach of common actuarial techniques in the context of solvency II (corresponding to the II Objective)

- 2.35. The concepts referred to in the previous section do not in general contradict the overall Solvency II framework and the undertakings may introduce those methods into their calculation frameworks. However, these common techniques have to be aligned with the principles defined in the implementing measures. If there would be no harmonised way to implement actuarial techniques, some compliance costs for undertakings would arise, when different supervisory practices should be applied inside Europe. This especially holds for insurance groups. It seems that the range of applied actuarial methods is too big and it would be high burden for undertakings to use commonly used standard methods and to explain the characteristics of those methods.
- 2.36. In Option 1 it may be necessary to modify those techniques in order to make them compliant with the supervisory practices in different countries. This could lead to high development costs when implementing those concepts and would finally increase the costs of undertakings.
- 2.37. Furthermore the choice and appropriateness of the methods have a huge impact on the quality of technical provisions. Option 2 could impair the quality of technical provisions calculation, in case a commonly used method would be used but is not appropriate for the undertaking.
- 2.38. Under Option 1, because only clarifications of the Requirements in the Implementing Measures have been made, no costs are to be expected.
- 2.39. On the contrary, Option 2 would be expensive to implement, because in most cases it is difficult to prescribe concrete methods which have to be used. Furthermore Option 2 is impossible to implement from a legal perspective, because the goal of defining guidelines is only to assure the harmonised application of the provisions in the Implementing Measures, not to overwrite them.
- 2.40. After having compared the costs and benefits, Option 1 has been chosen.
- 2.41. Impacts of Option 1 on policyholders. No direct effect on policyholders is to be expected. Reduced costs of undertakings could lead to decreased premiums of policyholders. Another indirect effect is the positive benefit of a harmonised calculation of technical provisions.
- 2.42. Impacts of Option 1 on undertakings. Insurance undertakings can be sure that they in general are allowed to apply common actuarial techniques. By defining clear conditions when the methods can be used is positive from undertakings point of view. By clearly defined requirements they have a clear picture how to modify existing techniques to comply with Solvency II.
- 2.43. By harmonised requirements undertakings do not need to modify the techniques country by country, which may facilitate cross-border business. The definition of common standards would enable software providers to develop European-wide solutions with common actuarial techniques, which could decrease development costs and thus decrease costs of undertakings.
- 2.44. Impacts of Option 1 on NSAs. No costs to be expected for NSAs. NSAs may benefit from clear checks which have to be implemented by undertakings.

Furthermore due to similar approach of principles across Europe, group supervision may be facilitated.

- 2.45. The NSAs may also benefit from the experiences of other NSAs because the results are comparable and the experiences of supervisory practices may be compared with each other. This facilitates especially the small NSAs that have few undertakings in their markets and fewer statistics.
- 2.46. A common approach may also enable analysing the whole European insurance market, different stress tests as an example.
- 2.47. Impacts of Option 1 on financial stability. A common approach used by several undertakings may increase systemic risk if the same assumptions are used by several undertakings. This especially involves ESG's if there are few service providers and several undertakings apply the same ESG's.

Simplified calculation of technical provisions within the year (corresponding to the III Objective)

- 2.48. Quarterly reporting is a case where a simplification is justified, because a full calculation is normally expected to be too complex compared to its intended purpose. According to Article 129(4) of the Directive, the MCR needs to be calculated quarterly. This necessitates a quarterly calculation of technical provisions to derive the input values for the calculation of the MCR and to derive the OF.
- 2.49. Thus, to require a full calculation also within a year contradicts the overarching principle of proportionality and would imply unjustified burdens to undertakings. Hence, in terms of proportionality, it seems necessary that simplified calculations within a year are allowed. Also, in order to achieve harmonized practices, simplified methods seem to be needed.
- 2.50. Without further guidelines it could occur that there are NCAs which are more demanding than the others in regard to the requirements for quarterly reporting. The expenses of the quarterly reporting could differ across countries, which would mean a lack of harmonisation.
- 2.51. Furthermore there can be specific circumstances which may require a change in the assumptions of quarterly calculations. Adequate assumptions are important to ensure a harmonised, risk sensitive and prospective calculation of technical provisions.
- 2.52. The transparency of the valuation could be decreased if quarterly reporting is done very differently across countries.
- 2.53. Impacts on policyholders. There are mostly no impacts on policyholders.
- 2.54. Impacts on undertakings. For undertakings this policy option has positive impact because they can be sure that they can use simplified methods and that this allowance for simplified methods is similar across Europe. There are no costs related to this simplification because the undertaking may always choose to calculate the provisions accurately.
- 2.55. Impacts on NSAs. No costs to be expected for NSA's. However, they have to be more careful when relying on the quarterly data of the undertakings.

2.56. Impacts on financial stability. No impacts on financial stability are to be expected.

Guidance in the Use of Data Improvements and Estimations (corresponding to the VI Objective)

2.57. It is important to have good quality data in order to get reliable technical provisions.

2.58. If there would be no framework to determine e.g. how data can be adjusted and expert judgement used, there is a risk that the data is adjusted inappropriately or expert judgement is not used sufficiently. This assures appropriate data management systems. Otherwise this could reduce the quality of technical provisions calculation and decrease policyholders protection and transparency.

2.59. Impacts on policyholders. Defining processes for insurance undertakings will clearly have a positive effect on policyholders, because transparency is increased. Furthermore the quality of technical provisions would be increased.

2.60. Impacts on undertakings. The chosen policy option may result undertakings to avoid incentives to reduce their costs by implementing data management processes inappropriately. Legal security could be increased and thus compliance costs decreased when a common interpretation of data quality and their interaction with other topics exist.

2.61. The definition of common standards would enable software providers to develop European-wide solutions of data management systems, which could decrease development costs and thus decrease costs of undertakings.

2.62. It seems that more exact and reliable outcomes outweigh costs for undertakings.

2.63. Impacts on financial stability. This policy option has a positive contribution towards financial stability, because it assures a prospective and risk sensitive supervision. It is also expected that a more stable valuation of technical provisions will be achieved.

VI - Comparing the Options

2.64. In the light of the arising benefits and costs described in the previous section, EIOPA decided to adopt the following policy actions:

- Definition of assessments to ensure compliance with the Solvency II requirements;
- Definition of requirements for the use of common actuarial practices;
- Allowance for simplified calculation of technical provisions within the year and defining the requirements;
- Definition of further guidelines to allow for harmonised data handling and harmonised approach of data management.

2.65. The set of Guidelines concretises these policy decisions.

Chapter IV – Own Funds

3. Ancillary Own Funds

- 3.1. There are six Guidelines on this topic. EIOPA has considered the impact of the Guidelines on the main stakeholders: undertakings, supervisory authorities and policyholders.
- 3.2. EIOPA undertook a pre-consultation exercise with stakeholders in November 2011, and a public consultation was carried out between 2 June 2014 and 29 August 2014. Stakeholders' responses to these consultations were duly taken into account and served as a valuable input in order to revise the Guidelines.
- 3.3. The analysis has identified that there should be no incremental costs, because the Guidelines have a clarifying and explanatory goal, providing guidance on the way in which compliance should be achieved for the legislative requirements regarding the ancillary own fund approval process.
- 3.4. In each case, EIOPA is seeking to make explicit what undertakings and supervisory authorities are required to do on the basis of the combination of the Solvency II Directive and the Implementing Measures, thus improving certainty and consistency of application.
- 3.5. Therefore, for these six Guidelines no alternative options have been considered, because they do not involve any policy issue or choice. Nevertheless, their adoption is worthy because of their explanatory added value.

4. Classification of Own Funds

I - Procedural Issues and Consultation of Interested Parties

- 4.1. The assessment incorporates feedback received from a pre-consultation exercise in September 2011 and feedback from the public consultation which was carried out from 2 June 2014 to 29 August 2014. These comments were duly taken into account and served as a valuable input in order to improve the Guidelines.

II - Problem Definition

- 4.2. The Solvency II Directive provides for the classification of own fund items into three tiers based on characteristics and features set out in the Solvency II Directive and the Implementing Measures. In order to mitigate the risks of divergent supervisory practices or applications of Union law, additional clarification is needed in relation to a number of the concepts introduced in the Solvency II Directive and the Implementing Measures. In addition, a number of the provisions in the Solvency II Directive and the Implementing Measures require supervisory approval procedures to be established. Since these procedures are not specified, it is necessary to provide guidance on how they should operate, in order to ensure consistent and efficient supervisory practices. The specific areas where such problems were identified are described below.
- 4.3. **Treatment of encumbered items** – Articles 71(1)(o), 73 (1)(i) and 77(1)(h) of the Implementing Measures require basic own-fund items to be free from encumbrances and not connected with any other transaction that could undermine the ability of the item to display the features required of basic own-fund items. Without Guidelines, there is a risk of there not being a common understanding of where encumbrances may arise. Furthermore, without Guidelines, any adjustments required to the classification of own funds when an item is encumbered, including the calculation of the reconciliation reserve, might be inconsistently applied.
- 4.4. **Supervisory approval of repayment and redemption** – Articles 71(1)(h), 73(1)(d) and 77(1)(d) of the Implementing Measures require supervisory approval for the repayment and redemption of a basic own-fund item. Clarity is required as to when the undertaking should make an application for approval. Without Guidelines, different processes may be followed in different Member States which would give some undertakings a competitive advantage or disadvantage, having more or less flexibility in terms of capital management.
- 4.5. **Recognition of items as own funds once the intention to repay or redeem is known** – If an item is due to be repaid or redeemed in accordance with Articles 71, 73 or 77 of the Implementing Measures, it is necessary to determine when it should cease to be recognised as own funds.

- 4.6. ***Called up but not paid in Tier 2 basic own-fund items*** – Article 72 of the Implementing Measures allows called up own-fund items that are not yet paid in to count as Tier 2 basic own funds. It is important that own funds should not remain indefinitely called up but not paid in, as this would undermine the distinction between basic and ancillary own funds. In addition, while some Member States have provisions in national legislation that limit the time period for which shares can remain called but unpaid, not all Member States do so.
- 4.7. ***Incentives to redeem*** – Article 71(1)(i) of the Implementing Measures does not allow Tier 1 own-fund items to include any incentives to redeem, but Articles 73(1)(e) and 77(1)(e) allow Tier 2 and Tier 3 items respectively to contain limited incentives to redeem. The problem addressed is how to define incentives to redeem that are not limited.
- 4.8. ***Exceptional waiver for the cancellation of distributions*** - Article 71(1)(m) of the Implementing Measures allows the supervisory authority to exceptionally waive the requirement to cancel distributions on Tier 1 own-fund items in the event of non-compliance with the SCR. EIOPA needed to decide whether to specify how this waiver should operate and whether the use of an Alternative Coupon Satisfaction Mechanism (ACSM) should be permitted.

III - Objective Pursued

- 4.9. The policy objective of Solvency II own funds requirements is to ensure that undertakings hold sufficient high quality capital that absorbs losses when required to do so. This benefits policyholders in that undertakings should have the appropriate quality of own funds to mitigate unexpected losses.
- 4.10. EIOPA's objective with respect to the Guidelines on the classification of own funds is to support the above objective by:
- ensuring consistent implementation of the provisions for the classification of own funds between Member States, and
 - providing clarity for undertakings regarding the combined effect of the Solvency II Directive and the Implementing Measures.
- 4.11. In relation to the specific problems identified, EIOPA's objectives are as follows:
- To promote the accurate identification and appropriate treatment of encumbered items.
 - To promote consistent supervisory practices by specifying how the process of supervisory approval of repayment and redemption should operate including a time period.
 - Regarding the recognition of items as own funds once there is an intention to repay or redeem, to ensure that undertakings' solvency positions are accurately reflected both on an immediate and forward-looking basis. Ultimately, this will benefit policyholders since undertakings will be adequately capitalised to mitigate unexpected losses.
 - Regarding the treatment of called up own-fund items that are not yet paid in, to promote a consistent approach by providing a timeframe in which items should become paid in.
 - Regarding incentives to redeem, to help achieve consistent application of the regulations across Member States by further defining the concept of incentives to redeem.
 - Regarding the exceptional waiver for the cancellation of distributions, by further defining the concept, to help achieve consistent application of the

regulations across Member States and ensure that only distributions that do not further weaken the solvency position of an undertaking are permitted.

IV - Policy Options

- 4.12. There are 27 Guidelines concerning the classification of own funds. Some of the Guidelines are necessary to clarify or fulfil the intent of the Solvency II Directive and Implementing Measures and no policy issues were at stake. Where this is the case, in 18 of the Guidelines, no alternative options were considered and no incremental costs were considered to result. The remaining nine Guidelines are the result of policy decisions by EIOPA for which various options were considered and their impacts on undertakings, policy holders and supervisory authorities analysed.
- 4.13. Policy issue 1: As for ***Treatment of encumbered items (Guideline 14)***, EIOPA considered two alternative choices:
- (i) Option 1 - Provide high level principles on how to assess encumbrances on a substance over form basis;
 - (ii) Option 2 - Provide a more detailed approach including examples.
- 4.14. Policy issue 2: As for ***Supervisory approval of repayment and redemption (Guideline 18)***, regarding the time period to allow the regulatory process to operate, EIOPA considered two alternative options:
- (i) Option 1 - Define the period of time as a reasonable period of time;
 - (ii) Option 2 - Define a specific period of time e.g. 6 months, 3 months or 1 month after the item was called.
- 4.15. Policy issue 3: As for the ***Recognition of items as own funds once the intention to repay or redeem is known (Guidelines 7, 11 and 12)***, three alternative options were considered:
- (i) Option 1 - To cease recognition as soon as the request for approval is submitted;
 - (ii) Option 2 - To cease recognition on the date of repayment or redemption;
 - (iii) Option 3 - To cease recognition on the date that notice is given to the holders of the own-fund item.
- 4.16. Policy issue 4: As for ***Called up but not paid in Tier 2 basic own-fund items (Guideline 10)***, two alternative options were considered:
- (i) Option 1 - To define the period of time as "a reasonable period of time";
 - (ii) Option 2 - To define a specific period of time e.g. 6 months, 3 months or 1 month after the item was called.
- 4.17. Policy issue 5.1: As for ***Incentives to redeem (Guideline 19)***, incentives to redeem may result from a specific contractual term or a combination of contractual terms governing an own-fund item. In this issue, two options were considered:
- (i) Option 1 - To define a narrow list of contractual terms that constitute incentives to redeem; or
 - (ii) Option 2 - To describe the features of outcomes that would be considered an incentive to redeem.

- 4.18. Policy issue 6: As for the **Exceptional waiver for the cancellation of distributions (Guidelines 5 and 17)**, two alternative options were discussed:
- (i) Option 1 - To further specify how such an ACSM should operate; or
 - (ii) Option 2 - To allow market participants to make their own arrangements.

V. Analysis of Impact

- 4.19. With the intention to meet the objectives set out above, EIOPA has analysed the different policy options including their respective expected positive and negative impacts.

Treatment of encumbered items

- 4.20. For the **Treatment of encumbered items**, costs and benefits of alternative options are summarised below:

Option (i): provide high level principles on how to assess encumbrances on a substance-over-form basis.

Benefits: this will benefit supervisory authorities and policy holders as it will encourage supervisory authorities and undertakings to consider the economic substance of arrangements as opposed to their legal form. In this way, undertakings' own funds are more likely to be in compliance with the regulations.

Costs: There may be some uncertainty for undertakings as to what exactly constitutes an encumbrance.

Option (ii): Provide a more detailed approach including examples.

Benefits: This would increase understanding for undertakings as to what exactly constitutes an encumbrance.

Costs: There may still be some uncertainty for undertakings as to what exactly constitutes an encumbrance.

Supervisory approval of repayment and redemption

- 4.21. The advantage of using 'a reasonable period of time' is that it provides some flexibility to consider what is reasonable based on existing national legislation or market practices. However, this does not ensure a consistent application across Member States. Because a key aim of the Solvency II Directive is harmonisation across Member States, using 'a reasonable period of time' was not considered to be an appropriate solution.
- 4.22. Setting a long specific time period may impact on undertakings' processes and opportunities for issuing new own-fund items. Undertakings often replace repaid or redeemed own-fund items. Any delay to the repayment or redemption process may cause undertakings to miss the opportunity for issuing new own-fund items due to movements in financial markets. This would suggest a short time period is appropriate, for example 1 month.

- 4.23. On the other hand, supervisory authorities and undertakings should be more inclined towards preserving own funds in times of market volatility. A longer time period allows the supervisory authority sufficient time to consider whether a potential depletion of own funds should be permitted bearing in mind the financial condition of the undertaking and the market circumstances. This would suggest a longer time period is appropriate, such as 3 or 6 months.
- 4.24. For the time period for supervisory approval of repayment and redemption (Guideline 18), the additional costs and benefits of alternative options are summarised below:

Option (i): To define the period of time as 'a reasonable period of time'.

Benefits: This provides flexibility for supervisory authorities and undertakings to consider what is reasonable based on existing national legislation or market practices.

Costs: The option undermines the objective of harmonisation.

Option (ii): To define a specific period of time e.g. 6 months, 3 months or 1 month after the item was called.

Benefits: A specific period of time creates more harmonisation. A 3 month period of time would be sufficient to allow the supervisory authority to process the application. EIOPA also judged that the 3 month period would be compatible with national law in most jurisdictions.

Costs: In some Member States, it would introduce an additional regulatory process where previously there was none. Undertakings may not be able to react to short-term opportunities for raising own funds, where the repayment or redemption of an existing instrument is part of the process.

Recognition of items as own funds once the intention to repay or redeem is known

- 4.25. An argument in favour of maintaining recognition until the own-fund item is repaid or redeemed (Option (ii)) is that until that date, the own-fund item should be available to absorb losses. However, this is contingent on both the undertaking's and the supervisory authority's ability to prevent the repayment or redemption once notice has been given. In non-stressed situations, it is unlikely that either an undertaking or the supervisory authority will reverse the intention to repay or redeem an own-fund item.
- 4.26. Costs and benefits for options regarding the recognition of items as own funds once the intention to repay or redeem is known are summarised below:

Option (i): To cease recognition as soon as the request for approval is submitted.

Benefits: For supervisory authorities and policyholders, the solvency position of the undertaking would reflect the

expected repayment or redemption at the earliest possible opportunity.

Costs: For undertakings, recognition would cease at the earliest point even though it is not certain that the item will be repaid or redeemed because approval may not be given.

Option (ii): to cease recognition on the date of repayment or redemption

Benefits: For undertakings, this would permit recognition for the longest possible time.

Costs: For supervisory authorities and policyholders, the solvency position of the firm would not reflect that the repayment or redemption is practically certain at a much earlier point.

Option (iii): to cease recognition on the date that notice is given to the holders of the own funds item

Benefits: For undertakings and supervisory authorities it is prudent to exclude an item once the holders of that item have been informed of the intention to repay or redeem the item. This will benefit policyholders in that undertakings will be adequately capitalised to mitigate unexpected losses.

Costs: There is a cost to undertakings in that own funds will not be recognised for a short period prior to the date of repayment or redemption.

Called up but not paid in Tier 2 basic own-fund items

4.27. The Guidelines address the issue of the timeframe in which Tier 2 basic own-fund items should become paid in so as to provide a consistent approach.

4.28. The time period defined must allow sufficient time for the item to become paid in, whilst still setting a limit that is acceptable from a supervisory point of view. In this regard, consideration was given to existing member state legislative provisions.

4.29. Costs and benefits for options regarding Tier 2 basic own fund items which have been called up but not paid in are summarised below:

Option (i): To define the period of time as 'a reasonable period of time'.

Benefits: This provides flexibility for supervisory authorities and undertakings to consider what is reasonable based on existing national legislation or market practices.

Costs: The option undermines the objective of harmonisation.

Option (ii): To define a specific period of time e.g. 6 months, 3 months or 1 month after the item was called.

Benefits: This option creates more harmonisation. It protects policyholders in that called up capital cannot remain not paid in for an indefinite period of time.

Costs: It may limit the flexibility that is currently available in some Member States.

Limited incentives to redeem: definition of incentives to redeem

4.30. Defining a narrow list of contractual terms that constitute incentives to redeem, Option (i), has the advantages of increased certainty and promoting a harmonised approach. However, it creates the opportunity for the intention of the Solvency II regulations to be circumvented, if contractual terms are formulated that deliver the effect of an incentive to redeem, but which do not appear on a defined list of recognised contractual terms.

4.31. Describing the features of outcomes that would be considered an incentive to redeem, Option (ii), has the advantage of prioritising substance over form. A disadvantage is that it is hard to ensure consistent application of the regulations.

4.32. Costs and benefits for options regarding the definition of incentives to redeem are summarised below:

Option (i): to define a narrow list of contractual terms that constitutes incentives to redeem

Benefits: This would create certainty for undertakings and supervisory authorities.

Costs: It would represent a risk to policyholders in that incentives to redeem that were not on the list might be permitted thereby undermining the quality of capital and policyholder protection.

Option (ii): to describe the features of outcomes that would be considered an incentive to redeem

Benefits: This option would allow sufficient flexibility for supervisory authorities to maintain the quality of capital which in turn would protect policyholders.

Costs: There will not be a definitive list of incentives to redeem which may cause some uncertainty for undertakings.

Exceptional waiver for the cancellation of distributions

4.33. A distribution that does not further weaken the solvency position of an undertaking is not easily achieved. Current market practice attempts to do this

with ACSM, but the operation of these has not always been successful from a supervisory perspective as they have led to a further weakening of the solvency position.

- 4.34. Costs and benefits for options regarding the exceptional waiver of the cancellation of distributions are summarised below:

Option (i): to further specify such ACSM

Benefits: This option would allow supervisory authorities to apply the regulations consistently, thereby maintaining the quality of capital which in turn would protect policyholders.

Costs: EIOPA judged that there were no significant costs to this approach, as the Guidelines aim only to achieve consistent application of the regulations.

Option (ii): to allow market participants to make their own arrangements

Benefits: It would provide flexibility to undertakings.

Costs: Undertakings may invest unproductively in such arrangements in the absence of further Guidelines.

VI - Comparing the Options

Treatment of encumbered items

- 4.35. On the basis of the analysis and feedback from the stakeholders, EIOPA decided on a combination of the two options. EIOPA judged that substance-over-form arguments were important, but also that examples were needed to aid clarity. In particular whilst the Guidelines provide a list of examples of arrangements or transactions which are considered to result in encumbrances, it is made clear that the list is not exhaustive.

- 4.36. If attention is not drawn to the principle of substance-over-form, stakeholders are likely to focus more on what structures would constitute an encumbrance, rather than understanding that encumbrances should be judged using a substance-over-form approach. It is important for undertakings to take account of any transaction that may affect the ability of an item to meet the criteria for classification. The examples provided in the explanatory text are thus for illustrative purposes and should not be considered as an exhaustive list. They are intended to provide clarity on what constitutes an encumbrance.

Supervisory approval of repayment and redemption

- 4.37. EIOPA judged that the benefits of harmonisation from setting a specific period would outweigh the associated costs, and thus decided on option (ii). The preferred option was to require undertakings to request supervisory approval 3 months before the earlier of the contractual notice to holders or the repayment or redemption date. EIOPA judged this period of time as sufficient to allow the supervisory authority to process the application without causing undue burden to the undertaking. EIOPA felt that repayment or redemption should not be

based on an opportunistic process, but rather as part of a medium-term capital plan. In this context 3 months was not deemed to be a long time. EIOPA also judged that the 3-months period would be compatible with national law in most Member States.

Recognition of item as own funds once the intention to repay or redeem is known

4.38. EIOPA decided on option (iii). Except in times of stress, the undertaking has a legal obligation to pay the holders of the item once notice has been given; thus at this point the undertaking should not be able to rely on that item to meet its capital requirements and the item should cease to be considered as own funds. This forms part of prudent capital management and there is a precedent for this in Solvency II in the treatment of foreseeable dividends. In the circumstances where no notice is required, the date of supervisory approval of repayment or redemption should be the point at which recognition ceases.

Called up but not paid in Tier 2 basic own-fund items

4.39. The preferred option was to set the time period, in which an item should become paid in, of within 3 months. The advantage of using 'a reasonable period of time', Option (i), would have been to provide Member States with flexibility to interpret the term reasonable based on existing national legislation or market practices, thereby potentially limiting the costs of new regulatory processes.

4.40. However, this does not ensure a consistent application across Member States. Having in mind that a key aim of the Solvency II Directive is harmonisation across Member States, using 'a reasonable period of time' was not considered to be an appropriate solution. This is why Option (ii) is preferred. This will promote consistency of approach, but would also not prevent a shorter time period being defined under national legislation.

Limited incentives to redeem: definition of incentives to redeem

4.41. EIOPA opted for a combination of Options (i) and (ii). EIOPA deemed it necessary to provide a list of contractual terms that would constitute incentives to redeem. This provides a reasonable degree of certainty for undertakings and ensures consistent application with regard to these particular arrangements. However, in recognition that it is possible for other arrangements to constitute incentives to redeem, EIOPA also specified that this list should not be considered exhaustive and therefore chose to describe the features of outcomes that would be considered an incentive to redeem.

Exceptional waiver for the cancellation of distributions

4.42. EIOPA judged that it is beneficial to provide further clarification and details about the operation of ACSM and thus decided on option (ii). Without further definition, it is possible that undertakings may expend time and resource developing ACSM structures which would not meet the criteria. It is also likely that there would be a lack of harmonisation across Member States.

5. Ring-Fenced Funds

I - Procedural Issues and Consultation of interested Parties

5.1. This impact assessment incorporates feedback received from a pre-consultation exercise which closed in February 2012, and feedback from the public consultation which was carried out from 2 June 2014 to 29 August 2014. These comments were duly taken into account and served as a valuable input in order to improve the Guidelines.

II - Problem Definition

5.2. The Solvency II Directive and the Implementing Measures require undertakings to make an adjustment to their own funds if own-fund items within a ring-fenced fund have a reduced capacity to absorb losses on a going-concern basis, due to their lack of transferability within the undertaking.

5.3. The Solvency II Directive and the Implementing Measures also contain a rebuttable assumption that there is no diversification of risks between ring-fenced funds within an undertaking, and also that there is no diversification between any ring-fenced fund and the remaining part of the undertaking.

5.4. However, the Solvency II Directive and the Implementing Measures require clarification in order to provide for their consistent application. In particular, EIOPA judged that guidance is necessary with regard to the:

- identification of a ring-fenced fund;
- treatment of a non-material ring-fenced fund;
- calculation of a ring-fenced fund's notional SCR and own funds; and
- calculation of undertaking's overall SCR in the presence of a ring-fenced fund.

III - Objective Pursued

5.5. The general policy objective of Solvency II is the protection of policyholders.

5.6. The specific policy objectives of Solvency II own funds requirements are to ensure that undertakings hold sufficient quality own funds to absorb losses when required to do so.

5.7. The Guidelines on ring-fenced funds are intended to support the above objectives by ensuring consistent implementation between Member States and providing clarity for supervisory authorities and undertakings. In particular, the guidelines aim to provide clarity in the following eight areas:

- identification of ring-fenced funds (**Guidelines 1-4**);
- materiality (**Guideline 5**);
- identification of assets and liabilities within a ring-fenced fund (**Guidelines 6-8**);
- calculation of a notional SCR (**Guidelines 9-10**);
- determining whether restricted own funds within a ring-fenced fund exceed the notional SCR (**Guideline 11**);

- calculation of an overall SCR using the standard formula (**Guideline 12**);
- application of calculation methodology to similar ring-fenced funds (**Guideline 14**);
- reduction of diversification benefit on account of ring fenced funds where an internal model is used to calculate the Solvency Capital Requirement (**Guidelines 13, 15 and 16**);and
- how the SCR spilt by risk modules can be reported in the case of ring-fenced funds (**Guideline 17**).

5.8. The effects of the Guidelines are assessed against the baseline described in the Introduction. For the Guidelines on ring-fenced funds the baseline refers to Articles 99 and 111(h) of the Solvency II Directive, as supplemented by Articles 80, 81, 216 and 217 of the Implementing Measures. Effects are incremental with respect to those already created by the baseline.

IV - Policy Options

5.9. Regarding the first area above, **identification of ring fenced funds**, Article 80 of the Implementing Measures requires undertakings to adjust their reconciliation reserve if own-fund items within a ring-fenced fund have a reduced capacity to fully absorb losses on a going-concern basis, due to their lack of transferability within the undertaking.

5.10. EIOPA Guidelines are needed to ensure that undertakings are consistent in their identification of ring-fenced funds. To achieve this, EIOPA discussed two alternative options:

- Option (a): to include within the Guidelines an exhaustive list of arrangements which it considered to be ring-fenced funds, or
- Option (b): to describe within the Guidelines the general characteristics of ring-fenced funds and include an illustrative but non-exhaustive list.

5.11. Regarding the second area above, **materiality**, Article 81 of the Implementing Measures allows undertakings to avoid performing an adjustment to own funds if the ring-fenced fund in question is not material. In such circumstances, all of the own funds within the ring-fenced fund should be deducted from the undertaking's own funds.

EIOPA Guidelines are needed to ensure that undertakings are consistent in their identification of non-material ring-fenced funds. To achieve this, EIOPA discussed two alternative options:

- Option (a): to provide narrow criteria for what qualifies as material in order to minimise the burden on undertakings and the potential for "over-reporting" of what may be considered non-relevant items; or
- Option (b): to provide broader criteria in order to capture a larger number of arrangements.

5.12. Regarding the remaining areas above, EIOPA considered that Guidelines 6 to 17 all clarify the requirements in the Solvency II Directive and the Implementing Measures without adding requirements or costs. Thus, these Guidelines are not further discussed within this Impact Assessment. However, by enhancing clarity, these Guidelines add benefit and their adoption can be considered beneficial.

V - Analysis of Impact

Identification of ring-fenced funds

5.13. Regarding the first area, identification of ring fenced funds, the main benefits and costs of the two options considered by EIOPA are described below.

Option (A)

5.14. As noted above, Option (A) would consist of Guidelines containing an exhaustive list of arrangements considered to be ring-fenced funds.

5.15. *Benefits and costs for supervisory authorities* - An exhaustive list would give supervisory authorities greater clarity regarding which arrangements give rise to ring-fenced funds. This may contribute to more resource efficient supervision of ring-fenced fund requirements. It might also result in less supervisory time being spent in discussion with undertakings regarding individual arrangements.

5.16. However, there would be a cost to supervisory authorities of recording new arrangements and proposing updates to the list. An exhaustive list might also encourage undertakings to alter their arrangements so they fall outside the scope of the list, while the effect on own funds remains unchanged.

5.17. *Benefits and costs for undertakings* - An exhaustive list would give undertakings greater clarity regarding which arrangements give rise to ring-fenced funds. This might result in less time being spent in discussion with supervisory authorities regarding individual arrangements.

5.18. However, undertakings might fail to reflect all restrictions on assets or own funds when calculating their own funds and capital requirements, causing them to have fewer own funds and lower capital requirements than would be consistent with their risk profile.

5.19. *Benefits and costs for policyholders* - EIOPA did not identify any clear benefits to policyholders posed by Option (A).

5.20. An exhaustive list might encourage undertakings to structure arrangements in order to avoid the application of the ring-fenced fund regime even though there are restrictions on the associated assets and liabilities.

5.21. Policyholder protection would depend on regulatory responsiveness to innovation in undertaking's arrangements (i.e. the frequency of changes to the list). If this responsiveness were slow, policyholders might be at risk of inadequate protection.

5.22. In addition, undertakings might fail to take into account all restrictions on assets or own funds when calculating their own funds and capital requirements. This could lead to undertakings having fewer own funds and lower capital requirements than would be optimal to ensure their solvency given these restrictions.

Option (B)

- 5.23. Option (B) would consist of Guidelines describing general characteristics of ring-fenced funds and would include an illustrative but non-exhaustive list of arrangements considered to be ring-fenced funds.
- 5.24. *Benefits and costs for supervisory authorities* - A description of general characteristics of ring-fenced funds would give supervisory authorities increased discretion to identify arrangements giving rise to ring-fenced funds. Moreover, Guidelines containing general characteristics would have the flexibility to capture innovations without necessarily needing to be updated.
- 5.25. However, a description of general characteristics would give supervisory authorities less clarity on whether individual arrangements give rise to ring-fenced funds. More resources would be needed to determine on a case-by-case basis whether individual arrangements give rise to ring-fenced funds.
- 5.26. *Benefits and costs for undertakings* - A description of general characteristics of ring-fenced funds would enable undertakings' calculations of their SCR and own funds to more accurately reflect the availability of own funds within undertakings. Undertakings would hold an amount of own funds and have capital requirements consistent with their risk profiles.
- 5.27. However, a description of general characteristics would provide undertakings with less clarity regarding whether individual arrangements give rise to ring-fenced funds. Undertakings might need to spend more time clarifying the position of individual arrangements with their supervisory authority.
- 5.28. *Benefits and costs for policyholders* - A description of general characteristics of ring-fenced funds would potentially afford policyholders increased protection. Undertakings would have less scope to structure their arrangements in order to avoid the application of the ring-fenced fund regime in the presence of restrictions on assets or own funds. Moreover, policyholder protection would not depend upon the frequency of changes to an exhaustive list. Additionally, supervisory authorities would be freer to exercise judgement regarding whether individual arrangements give rise to ring-fenced funds, offering policyholders a greater degree of protection.
- 5.29. EIOPA did not identify any clear costs to policyholders posed by Option (B).

Materiality

- 5.30. Regarding the second area, materiality, the main benefits and costs of the two options considered by EIOPA are described below.

Option (A)

- 5.31. Option (A) would consist of Guidelines containing narrow criteria for what arrangements qualify as a material ring-fenced fund.
- 5.32. *Benefits and costs for supervisory authorities* - If the Guidelines contained narrower criteria regarding what arrangements qualify as material, fewer arrangements would be likely to qualify as material ring-fenced funds. This could reduce supervisory authorities' resource costs associated with reviewing undertakings' ring-fenced fund related disclosures.

- 5.33. However, narrower criteria may cause supervisory authorities to receive the calculations described in Guidelines from 6 to 14 for a smaller number of ring-fenced funds. They would thus have less information regarding ring-fenced funds and their impact upon the solvency of undertakings. This may inhibit their ability to pursue their regulatory objectives.
- 5.34. *Benefits and costs for undertakings* - Narrower criteria for what counts as material might decrease the number of ring-fenced funds for which undertakings must:
- calculate a notional SCR;
 - consider adjustments to own funds;
 - reflect a reduced scope for diversification.

This could save undertakings administrative costs and might also reduce their capital compliance costs.

- 5.35. However, narrower criteria for what counts as material might mean that undertakings hold fewer own funds and have lower capital requirements than would be needed in view of the presence of restrictions on the availability of assets and own funds. This may negatively impact their solvency.
- 5.36. *Benefits and costs for policyholders* - EIOPA did not identify any clear benefits to policyholders posed by option (a).
- 5.37. However, narrower criteria for what counts as material might encourage undertakings to structure arrangements in order to avoid the calculation approach for a material ring-fenced fund. This may cause undertakings to have fewer own funds and lower capital requirements than would be consistent with their risk profile. This would present a risk for policyholder protection.

Option (B)

- 5.38. Option (B) would consist of Guidelines containing broader criteria so as to capture a larger number of arrangements.
- 5.39. *Benefits and costs for supervisory authorities* - If the Guidelines contained broader criteria regarding what arrangements qualify as material, supervisory authorities would potentially receive the calculations described in the Guidelines for a larger number of ring-fenced funds. They would thus have more information regarding ring-fenced funds and their impact upon the solvency of undertakings. This increased transparency might help them to ensure an appropriate degree of policyholder protection in support of their regulatory objectives.
- 5.40. Broader criteria might also encourage greater accuracy in how undertakings measure their own funds and capital requirements, given the existence of restrictions on undertakings' use of assets or own funds. Undertakings' capital position would thus more accurately reflect their risk profile, consistent with supervisory authorities' regulatory objectives.
- 5.41. EIOPA did not identify any clear costs to supervisory authorities posed by option (B).

- 5.42. *Benefits and costs for undertakings* - If the Guidelines contained broader criteria regarding what arrangements qualify as material, undertakings with relatively small but material ring-fenced funds (i.e. which would satisfy broader criteria for materiality) may benefit from greater accuracy in how they measure their own funds and capital requirements, given the existence of genuine restrictions on undertakings' use of restricted assets or own funds. Undertakings' capital position would be more consistent with their risk profile.
- 5.43. However, undertakings may incur higher administration costs if broader criteria increase the number of ring-fenced funds for which the notional SCR have to be computed, potential adjustments to own funds considered, and reduced scope for diversification taken into account. Undertakings may also incur higher capital compliance costs in relation to small but material ring-fenced funds (which would be non-material under narrower criteria), given the potential for:
- deductions of surplus own funds held within these ring-fenced funds from total own funds; and
 - reduced scope for diversification between ring-fenced funds and the remaining part of the undertaking's business.
- 5.44. *Benefits and costs for policyholders* - Policyholders would be likely to benefit from broader criteria regarding materiality. Broader criteria would encourage greater accuracy in how undertakings measure their own funds and capital requirements, given the existence of restrictions on undertakings' use of assets or own funds. Undertakings' capital position would thus more accurately reflect their risk profile, enhancing policyholder protection. Additionally, supervisory authorities may have more information on ring-fenced funds and their impact upon the solvency of undertakings. This increased transparency might help them to ensure an appropriate degree of policyholder protection.
- 5.45. EIOPA did not identify any clear costs to policyholders posed by Option (B).

VI - Comparing the Options

Identification of ring-fenced funds

- 5.46. Regarding this first area, the main costs and benefits of the two options considered by EIOPA may be summarised as follows:

	<i>Option (A): Exhaustive list of ring-fenced fund arrangements</i>	<i>Option (B): Outline of characteristics and non-exhaustive list</i>
1. Benefit to supervisory authorities	<ul style="list-style-type: none"> - More clarity regarding which arrangements are ring-fenced funds. This may facilitate more efficient supervision. - Fewer resources likely to be needed to evaluate individual arrangements. 	<ul style="list-style-type: none"> - Increased discretion to identify arrangements giving rise to ring-fenced funds. - Flexibility to capture innovations without necessarily needing to be updated.
2. Benefit to undertakings	<ul style="list-style-type: none"> - More clarity regarding which arrangements give rise to ring-fenced funds. - Less time in discussion with supervisory authorities on individual arrangements. 	<ul style="list-style-type: none"> - Calculations of the capital requirements and own funds consistent with the risk profile.

	<i>Option (A): Exhaustive list of ring-fenced fund arrangements</i>	<i>Option (B): Outline of characteristics and non-exhaustive list</i>
3. Benefit to policyholders	<ul style="list-style-type: none"> - No clear benefits to policyholders. 	Greater degree of protection: <ul style="list-style-type: none"> - Less scope for undertakings to structure their arrangements in order to avoid the application of the ring-fenced fund regime. - More flexibility for supervisory authorities when analysing individual arrangements.
4. Cost to supervisory authorities	<ul style="list-style-type: none"> - Cost of recording new arrangements and proposing updates to the list. - Eventual incentive for undertakings to alter their arrangements so they fall outside the scope of the list. 	<ul style="list-style-type: none"> - Less clarity on whether individual arrangements give rise to ring-fenced funds. - More resources needed to analyse individual arrangements on a case-by-case basis.
5. Cost to undertakings	<ul style="list-style-type: none"> - Fewer own funds and lower capital requirements than would be consistent with their risk profile. 	<ul style="list-style-type: none"> - Less clarity regarding whether individual arrangements give rise to ring-fenced funds. - More time clarifying the position of individual arrangements with their supervisory authority.
6. Cost to policyholders	Risks to policyholder protection: <ul style="list-style-type: none"> - Undertakings may have inadequate own funds and capital requirements. - Dependence on regulatory responsiveness to innovation in undertakings' arrangements (i.e. the frequency of changes to the list). 	No clear cost to policyholders.

5.47. After considering these benefits and costs, EIOPA concluded that an exhaustive list would not be appropriate. The preferred option is to outline the general characteristics of ring-fenced fund arrangements and to include an illustrative but non-exhaustive list of some of these.

5.48. EIOPA decided that while it might be possible to list all the types of existing arrangements that give rise to a ring-fenced fund, such a list would not provide the necessary flexibility to adapt to future market innovation and capture appropriate new arrangements. Additionally, any rigid codification of arrangements that are ring-fenced funds would increase the chance that existing arrangements could be restructured so as to fall outside the scope of the list (while their economic effect on the own funds of an undertaking would remain unchanged). This could potentially compromise policyholder protection.

5.49. Guideline 4 (about the types of ring fenced funds) outlines the types of ring-fenced fund that, as a minimum, an undertaking should consider when identifying ring-fenced funds within its business. This should therefore limit additional costs to EIOPA and national supervisory authorities regarding the need to constantly update the list, and the resulting costs to undertakings of keeping up to date with requirements.

Materiality

5.50. Regarding the second area, materiality, the main costs and benefits of the two options considered may be summarised as follows:

	<i>Option (A): Narrower criteria for what constitutes material (i.e. fewer and larger ring-fenced funds captured)</i>	<i>Option (B): Broader criteria for what constitutes material (i.e. more and smaller ring-fenced funds captured)</i>
1. Benefit to supervisory authorities	- Lower supervisory authorities' resource costs associated with reviewing undertakings' ring-fenced fund related disclosures.	- More information regarding ring-fenced funds and their impact upon the solvency of undertakings. - Greater accuracy in how undertakings measure their own funds and capital requirements, given the existence of restrictions on undertakings' use of assets or own funds.
2. Benefit to undertakings	- Reduced numbers of ring-fenced funds for which undertakings must calculate a notional SCR, consider adjustments to own funds and reflect a reduced scope for diversification. This could save undertakings administrative costs and might also reduce their capital compliance costs.	- Undertakings with small but material ring-fenced funds (which meet broader materiality criteria) may benefit from greater accuracy in how they measure their own funds and capital requirements.
3. Benefit to policyholders	- No clear benefit to policyholders.	Greater policyholder protection: - Greater accuracy in how undertakings measure their own funds and capital requirements. - Supervisory authorities may have more information on ring-fenced funds and their impact upon the solvency of undertakings.
4. Cost to supervisory authorities	- Less information regarding ring-fenced funds and their impact upon the solvency of undertakings.	- No clear cost to supervisory authorities.
5. Cost to undertakings	- Fewer own funds and lower capital requirements than would be needed in view of the presence of restrictions on availability of assets and own funds.	- Higher administration costs if broader criteria increase the number of ring-fenced funds for which the notional SCR have to be computed, potential adjustments to own funds considered, and reduced scope for diversification taken into account. - Undertakings may incur higher

	<i>Option (A): Narrower criteria for what constitutes material (i.e. fewer and larger ring-fenced funds captured)</i>	<i>Option (B): Broader criteria for what constitutes material (i.e. more and smaller ring-fenced funds captured)</i>
		capital compliance costs in relation to small but material ring-fenced funds (which would be non-material under narrower criteria).
6. Cost to policyholders	- Risks to policyholder protection if undertakings have fewer own funds and lower capital requirements than would be consistent with their risk profile.	- No clear cost to policyholders.

5.51. After considering these benefits and costs, EIOPA decided that the criteria used in the assessment of what constitutes a material ring-fenced fund should ensure that where there are restricted own funds within a ring-fenced fund that have a *non-de-minimis* impact on the SCR or capital position of the undertaking, such ring-fenced funds should be treated as material. This will require undertakings to perform an appropriate ring-fenced fund adjustment and take account of any impact upon diversification when calculating their SCR.

5.52. Arguments against this option include the significant amount of work undertakings must perform in order to consider an adjustment to own funds and the potential for reduced scope for diversification within their SCR, as compared with the potentially low value of the ring-fenced funds in question. Narrower criteria would decrease the number of ring-fenced funds that would be considered as material. A narrow criterion could be (i) an absolute amount of assets and liabilities; (ii) formulaic, for example where a ring-fenced fund represents a certain proportion of the undertaking's SCR; or (iii) mainly qualitative, such as measured in relation to the potential impact on the SCR generally.

5.53. However, despite these arguments against the adoption of broad criteria, EIOPA concluded that any single criterion would be arbitrary and would not include information relevant to the assessment of materiality.

5.54. In conclusion, the preferred options are:

Option (B): for the issue **identification of ring fenced funds**, to describe general characteristics of ring-fenced funds and include an illustrative but non-exhaustive list criteria; and

Option (B): for the issue **materiality**, to provide broader criteria in line with the meaning of material used in the Implementing Measures, in order to capture a larger number of arrangements.

6. Treatment of Related Undertakings including Participations

I - Procedural Issues and Consultation of interested Parties

- 6.1 This Impact Assessment incorporates feedback received from an EIOPA pre-consultation exercise in September 2013 and a public consultation carried out between 2 June 2014 and 29 of August 2014. These comments were duly taken into account and served as a valuable input in order to improve the Guidelines.
- 6.2 The pre-consultation exercise revealed some uncertainties regarding the treatment of indirectly held participations in financial and credit institutions, in response to which EIOPA developed two additional Guidelines. Stakeholders also proposed the inclusion of additional examples in the Explanatory Text, which EIOPA developed.
- 6.3 The comments received during the public consultation and EIOPA's responses to them are summarised in the section Feedback Statement of the Final Report.

II - Problem Definition

- 6.4 EIOPA considered that the Solvency II Directive and the Implementing Measures leave room for possible misunderstandings or multiple interpretations by undertakings and supervisory authorities, with respect to the treatment of related undertakings, with negative repercussions in terms of efficient supervision, construction of a European "level playing field" and the protection of policyholders.

Specific Issues

- 6.5 EIOPA identified the following five issues for which Guidelines were considered to be necessary in order to achieve consistency and clarity regarding the application of Articles of the Solvency II Directive and the Implementing Measures:
 - **Considerations regarding the definition of dominant or significant influence:** Article 212(2) of the Solvency II Directive requires that, where the participating undertaking exerts a dominant or significant influence over another undertaking, then that undertaking is considered to be a related undertaking;
 - **Considerations regarding the identification of a strategic participation:** Article 68(3) of the Implementing Measures rules that undertakings shall not deduct strategic participations as referred to in Article 171 of the Implementing Measures which are included in the calculation of the group solvency on the basis of method 1 as set out in Annex I to Directive 2002/87/EC;
 - **Considerations regarding the scope of calculations for Article 68 of the Implementing Measures:** this Article requires that for the purpose of determining the basic own funds of undertakings, basic own funds shall be reduced by the full value of participations in a financial or credit institution that exceed 10% of items included in points (i), (ii), (iv) and (vi) of Article 69 of the Implementing Measures; or by the part of the

value of all participations in financial and credit institutions that exceed 10% of items included in points (i), (ii), (iv) and (vi) of Article 69 of the Implementing Measures;

- ***Deductions in respect of participations in financial and credit institutions:*** Article 68(5) of the Implementing Measures reads that deductions according to Article 68(1) and (2) of the Implementing Measures shall be made from the corresponding tier in which the participation has increased the own funds of the related undertaking and spells out the modus operandi;
- ***Adjustments due to deductions of indirectly-held participations in financial and credit institutions:*** Where a deduction of the value of a participation in a financial or credit institution held indirectly is required, in full or in part, in accordance with Article 68 of the Implementing Measures, an adjustment is necessary at the level of the directly-held related undertaking in order to avoid double deductions.

III - Objective Pursued

- 6.6 The policy objective of Solvency II Own Funds requirements is to ensure that undertakings hold sufficient high quality capital that absorbs losses when necessary.
- 6.7 EIOPA's general objective with respect to these Guidelines was to provide clarity regarding the combined effect of the Solvency II Directive and the Implementing Measures and to create a "level playing field".
- 6.8 The Guidelines on the treatment of related undertakings support this objective by:
 - dealing with the treatment of participations in financial and credit institutions as one type of related undertakings, in regard to the determination of own funds of the participating undertaking.
 - covering the treatment of related undertakings concerning the calculation of the SCR; a complete and correct calculation of the SCR considering all relevant risks, including those stemming from investments in related undertakings, is necessary to identify the amount of own funds that is sufficient to cover the SCR.

IV - Policy Options

- 6.9 With the intention of meeting the objectives set out in the previous section, EIOPA has analysed different policy options including their respective expected positive and negative impact. This paper consists of 10 Guidelines.
- 6.10 Five Guidelines (Guideline 1, 3, 4, 6 and 7) have been judged to raise some policy issues with possible effects on undertakings, policy holders and supervisory authorities.
- 6.11 The other Guidelines (Guideline 2, 5, 8 and 9) have been judged to merely clarify the requirements without involving a policy choice by EIOPA or resulting in any impacts. Guideline 2 clarifies the link to Directive 2006/48/EC and to

Directive 2004/39/EC in respect of the identification of participations in financial and credit institutions. Guideline 5 clarifies the calculations necessary for the purposes of Article 68 of the Implementing Measures. Guideline 8 and 9 adapt the general approaches for standard formula users and for internal model users respectively, to the area of related undertakings without making any policy choices. The inclusion of Guideline 8 and 9 is also to provide a holistic view of the treatment of related undertakings.

- 6.12 As for **Guideline 1**, treating the issue *Considerations regarding the definition of dominant or significant influence*, EIOPA examined as alternative to the baseline scenario the options to:
- (i) Refer to the Accounting Directive; or to
 - (ii) Create a list with criteria that supervisory authorities should consider.
- 6.13 As for **Guideline 3**, treating the issue *Considerations regarding the identification of a strategic participation*, EIOPA examined as alternative to the baseline scenario the option to:
- (i) Further explain the terms that are used in Article 171 of the Implementing Measures.
- 6.14 As for **Guideline 4**, treating the issue *Considerations regarding the scope of calculations for Article 68 of the Implementing Measures*, EIOPA examined as alternative to the baseline scenario the option to:
- (i) Further explain the approaches that undertakings should apply.
- 6.15 As for **Guideline 6**, treating the issue *Deductions in respect of participations in financial and credit institutions*, EIOPA examined as alternative to the baseline scenario the option to:
- (i) Give further guidance to address specific situations not already covered in Article 68 of the Implementing Measures.
- 6.16 As for **Guideline 7**, treating the issue *Adjustments due to deductions of indirectly-held participations in financial and credit institutions*, EIOPA examined as alternative to the baseline scenario the option to:
- (i) Create guidelines to provide for clarification.

V - Analysis of Impact

- 6.17 As for **Guideline 1**, treating the issue *Considerations regarding the definition of dominant or significant influence*, EIOPA considered the two options set out in the previous section and recognised the following costs and benefits. Given the necessity to clarify previous levels of legislation, the two options have different properties in terms of additional costs and benefits:
- 6.18 Option (i) would provide more room for different interpretations by undertakings within the framework of the Accounting Directive, but this possible advantage in terms of flexibility would also bring the risk of lack of clarity and fragmented applications across the Union. The consequences of this would be the absence of a "level playing field", higher costs of supervision especially for multinational groups and finally lower protection for policyholders.

- 6.19 Option (ii) would have the benefit of providing clear criteria that supervisory authorities should consider when identifying a related undertaking on the basis that the participating undertaking can exert a dominant or significant influence over another undertaking. Moreover, these criteria would be consistent with the Solvency II provisions and principles and it would not be necessary to refer to a different set of rules.
- 6.20 As for **Guideline 3**, treating the issue *Consideration regarding the identification of a strategic participation*, paragraphs 1.22, 1.23 and 1.25 were considered to have possible impacts. These paragraphs cover the nature of the value of the equity investment (paragraph 1.22), the strategy of holding the participation for a long period and its consistency with the main policies guiding or limiting the actions of the undertaking (paragraph 1.23), and the consistency of the strategy of holding the participation for a long period with the main policies guiding or limiting the actions of the group, where the participating undertaking is part of a group (paragraph 1.25).
- 6.21 EIOPA recognised the following costs and benefits of adopting the option to concretise the terms that are used in Article 171 of the Implementing Measures.
- 6.22 On the side of the costs, EIOPA noted that Guidelines could generally create additional requirements resulting into additional costs for the undertakings.
- 6.23 However, on the side of the benefits, the option of providing additional guidance contributes to reaching a common understanding on the criteria and factors upon which the determination of a strategic participation is based, and to creating a "level playing field". In this respect, EIOPA considered that it is important for supervisory authorities to gain a common understanding of indefinite terms contained in the Implementing Measures and to seek to ensure that they are applied in a consistent way.
- 6.24 The costs and benefits can be further broken down to the three paragraphs in question:
- 6.25 Regarding paragraph 1.22 (valuation), on the side of the costs, undertakings could argue that they are able to adopt a simple approach in this respect and use values already contained in the statutory accounts if there was not guidance that the valuation needs to appropriate.
- 6.26 However, on the other hand, (and therefore a benefit of further explanation), this would not allow for a common understanding to be reached on different values of participations and would impede the creation of a "level playing field".
- 6.27 Regarding paragraphs 1.23 and 1.25, on the side of the costs, without Guidelines, undertakings could have more freedom in how to demonstrate the consistency of their strategy with the main policies.
- 6.28 However, on the side of the benefits, the specification of main policies would diminish uncertainty for undertakings and foster a shared understanding among supervisory authorities, which is important for strategic participations, given their different treatment.
- 6.29 As for **Guideline 4**, treating the issue *Considerations regarding the scope of calculations for Article 68 of the Implementing Measures*, EIOPA recognised the following benefits of adopting the option to further explain the approaches that

undertakings should apply: the complexity of calculations according to Article 68 of the Implementing Measures which is higher where there are participations in indirectly held financial and credit institutions, necessitates additional guidance.

- 6.30 EIOPA did not identify any costs associated with the suggested approaches.
- 6.31 As for **Guideline 6**, treating the issue *Deductions in respect of participations in financial and credit institutions*, EIOPA recognised the following benefits of adopting the option to give further guidance: the guideline would bring the additional advantage of clarifying higher levels of legislation, promoting consistent application of the regulatory framework across the Union, with positive effects in terms of a level playing field and the supervisory activity.
- 6.32 EIOPA did not identify any costs associated with the suggested approaches.
- 6.33 From this perspective, it is beneficial to provide Guidelines on the application of Article 68 of the Implementing Measures, in two situations where there might otherwise be misunderstandings. The first situation covers the case where items to be deducted are not classified into the tiers set out in Article 68 (5) of the Implementing Measures. The second situation occurs when the amount of the deduction exceeds the amount from which it is required to be deducted according to Article 71(5) of the Implementing Measures.
- 6.34 As for **Guideline 7**, treating the issue *Adjustments due to deductions of indirectly-held participations in financial and credit institutions*, EIOPA recognised the following benefits of adopting an alternative to the baseline: EIOPA noted it would bring the advantages of giving additional guidance and achieving clarity in the case of indirectly held participations in financial and credit participations, similar to the benefits of including Guideline 5 (see above).
- 6.35 EIOPA did not identify any costs.

VI - Comparing the Options

- 6.36 As for **Guideline 1**, treating the issue *Considerations regarding the definition of dominant or significant influence*, EIOPA decided to develop a list (Option (ii)) satisfying the characteristics of:
- giving a clear message which criteria are relevant for assessing whether a dominant or significant influence over another undertaking can be exerted;
 - including the criteria which prima facie argue for a dominant or significant influence; and
 - making clear that the list is not exhaustive and that a principle-based approach should be retained.
- 6.37 The possible flexibility that could be achieved with the reference to the Accounting Directive (Option (i)) is viewed as detrimental with respect to the risk of different understandings and fragmented applications by undertakings. Moreover, EIOPA wanted to follow an approach that fully reflects the Solvency II vocabulary and taxonomy. The creation of a list with criteria which should be considered provides clear points of reference for undertakings and also leaves room for additional criteria that may be relevant for the assessment of the supervisory authorities.

- 6.38 As for **Guideline 3**, EIOPA considers it to be beneficial to undertakings to have greater certainty regarding supervisory expectations for the demonstration requirements of Article 171 of the Implementing Measures. EIOPA concluded that terms as used in the Implementing Measures needed clarification. This can be further broken down to the paragraphs 1.22, 1.23 and 1.25 of Guideline 3.
- 6.39 Regarding paragraph 1.22, EIOPA felt it important to explain that the valuation needs to be consistent and appropriate over time to be able to demonstrate that the value of the equity investment is likely to be materially less volatile.
- 6.40 Regarding paragraphs 1.22 and 1.24, EIOPA felt it necessary to specify how the requirement to demonstrate that the nature of the investment is strategic, as set out in Article 171 of the Implementing Measures, should be met. Especially with regard to the main policies guiding or limiting the actions of the undertaking, EIOPA sought to clarify that, since the undertaking needs to evidence its strategy to hold the participation for a long period, consideration needs to be given to market conditions and other factors that may affect that strategy.
- 6.41 As for **Guideline 4**, EIOPA chose to provide further clarification to create a common understanding in the case of indirectly held participations because of questions and comments received from stakeholders. Because of the complexity of calculations according to Article 68 of the Implementing Measures, which is higher in the case of participations in indirectly held financial and credit institutions, it was necessary to give additional guidance.
- 6.42 As for **Guideline 6**, treating the issue *Deductions in respect of participations in financial and credit institutions*, EIOPA decided to provide Guidelines that further spell out the approach to be taken when:
- Items to be deducted are not classified into the tiers set out in Article 68(5) of the Implementing Measures;
 - The amount of the deduction exceeds the amount from which it is required to be deducted in accordance with Article 68(5) of the Implementing Measures.
- 6.43 In both situations EIOPA necessarily followed the modus operandi of Article 68(5) of the Implementing Measures. In the first situation, the logical approach is to make all deductions from the amount of items included in points (i), (ii), (iv) and (vi) of Article 69(a) of the Implementing Measures ("unrestricted Tier 1 items"). This is also the right approach for investments in subordinated liabilities that could in their best design only be regarded as "restricted Tier 1 items" and not as "unrestricted Tier 1 items". This prudential approach takes into account that a classification into tiers is unknown and should not be done by the supervisory authorities for the purpose of Article 68(5) of the Implementing Measures. Moreover, this approach to deduct from "unrestricted Tier 1 items" is not only a practical one, but also takes into account that usually the holding in the related undertaking would contribute to the excess of assets over liabilities which is Tier 1.
- 6.44 As for **Guideline 7**, EIOPA felt it necessary to cover this ground regarding adjustments due to deductions of indirectly-held participations in financial and credit institutions because of stakeholders' questions. EIOPA necessarily intended to be consistent with the general principles regarding the calculation of

the SCR, and deemed it important to develop a Guideline that addresses any double deductions.

- 6.45 All in all, the chosen options regarding the five issues most relevant for the Impact Assessment provide benefit whilst generating no significant costs above the baseline.

Chapter V – Solvency Capital Requirements

7. Look-Through Approach

I - Procedural Issues and Consultation of interested Parties

- 7.1 The EIOPA Guidelines on Look-Through Approach aim at increasing consistency and convergence of professional practice with respect to the application of the look-through approach in the standard formula for all types and sizes of undertakings.
- 7.2 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements from different national competent authorities and EIOPA.
- 7.3 Stakeholders were pre-consulted in the preparation of the Guidelines. Furthermore a public consultation of the Guidelines and its impact assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' comments were duly taken into account and served as a valuable input in order to revise the Guidelines.
- 7.4 Specific attention has been given to proportionality issues. When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation, please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".

II - Problem Definition

- 7.5 Article 84 of the Implementing Measures requires that undertakings apply a look-through approach in calculating their SCR according to the standard formula to investments in:
- collective vehicles and other investments packaged as funds;
 - any other indirect exposures to market risk;
 - material indirect exposures to underwriting and counterparty default risk.
- 7.6 Furthermore Article 84 of the Implementing Measures specifies that the look-through approach shall not apply to investments in related undertakings within the meaning of Article 212(1)(b) and 212(2) of Solvency II.
- 7.7 However the details and the implementation processes for performing such a look-through are not described in Solvency II or the Implementing Measures. In this context, the guidelines are needed to ensure a consistent and proportional implementation of the legislation, thus avoiding confusion and a weakening of the Solvency II Directive capital requirements. In particular if not made explicit, the treatment of money market funds could be misinterpreted, where they do not benefit from any particular exemption in the Directive or the Implementing Measures.

Proportionality

- 7.8 When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate.

Baseline Scenario

- 7.9 When analysing the impact from proposed policies, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention.
- 7.10 For the analysis of the potential related costs and benefits of the proposed guidelines on look-through, EIOPA has applied the baseline described in the Introduction, therefore taking into account the effect of the application the application of the Directive requirements and the relevant Implementing Measures (Article 84 of Implementing Measures).
- 7.11 In practice, starting from the combination of the prudent person principle and the Implementing Measures Article on Look-through, and for the only purpose of the analysis of costs and benefits, it has been considered appropriate to use as the reference for the comparison the requirement to apply the look-through approach in general (unless explicitly exempted in the Implementing Measures).

III - Objective Pursued

- 7.12 The EIOPA Guidelines on look-through aim to explain undertakings the process of looking-through in order to calculate their Solvency Capital Requirement (SCR). The guidelines set out how the look-through principle ought to be applied and the conditions for any departure from its full application.
- 7.13 The guidelines on looking-through underwriting exposures have the general aim of ensuring consistent capital charges for underlying risks irrespective of how they may be packaged.

IV - Analysis of Impact

- 7.14 Before analysing the different options foreseen, it is important to understand that the application of "look-through" can appear burdensome in some cases. Thus, some options developed below are actually providing useful additional practical guidance, in order to reduce the burden for undertakings compared to what would have been the legislation without those guidelines.

Guideline 1 (*Money market funds*)

- 7.15 The proposed Guideline clarifies that the look-through approach should be applied to money market funds, thereby ensuring consistency with other asset classes. In the case of packaged money market funds this requirement could be onerous for diversified funds; there is however no legal basis for an exemption of money market funds from the look-through requirements. This guidance is therefore clearly necessary.
- 7.16 Additional (with respect to the baseline) costs and benefits of having this guideline can be summarised as follows.
- 7.17 With regard to costs:
- On the side of undertakings: The Guideline does not impose any costs. However, the application of Article 84 of the Implementing Measures could be more onerous for diversified funds than other funds. But it is consistent with the prudent person principle and decreases the cost compared to the baseline altogether;
 - On the side of NSAs: None;
 - On the side of policy holders: None.
- 7.18 With regard to benefits:
- On the side of undertakings: clarity of the process to be followed.
 - On the side of NSAs: proportional, consistent and robust prudential outcomes;
 - On the side of policyholders: more adequate level of protection.

Guideline 2 (*Number of iterations*)

- 7.19 The proposed Guideline requires that the look-through is applied through several layers if necessary.
- 7.20 This ensures consistency and avoids arbitrary avoidance of the requirements through re-packaging. The requirements of the look-through approach may be onerous for funds of funds, and may in the longer term result in a disincentive for the creation of such layered arrangements; in the short-term it will likely lead to a once-off information gathering exercise in respect of complex existing funds.
- 7.21 Nevertheless, the use of these funds is not particularly exclusive to insurers and the same level of transparency should apply on the information coming from them as on information from other providers. This requirement is consistent with the reduction of opacity of fund structures however, and is unlikely to lead to significantly higher operating costs once fund managers have gathered the information on underlying assets that determines their risk features.
- 7.22 Additional (with respect to the baseline) costs and benefits of having this guideline can be summarised as follows.

- 7.23 With regard to costs:
- On the side of undertakings: The Guideline does not impose any costs. However, the application of the look-through approach can be more burdensome for multilayer funds than other funds. But it is consistent with the prudent person principle and decreases the cost compared to the baseline altogether;
 - On the side of NSAs: The Guideline in itself do not impose any costs and it clarifies an appropriate application of the Implementing Measures to calculate the capital requirements;
 - On the side of policy holders: none.
- 7.24 With regard to benefits:
- On the side of undertakings: clarity of the process to be followed.
 - On the side of NSAs: proportional, consistent and robust prudential outcome;
 - On the side of policyholders: more adequate level of protection.

Guideline 4 (*Investment in real estate*)

- 7.25 The Guideline provides clarification on the types of investments that have to be covered in the property risk sub-module and where a look-through approach should be applied.
- 7.26 With regard to benefits: The Guideline provides clarity on the appropriate application of the look-through approach for investments in real estate through collective investment undertakings or other investments packaged as funds.
- 7.27 With regard to costs:
- On the side of undertakings: None as it is merely a clarification on the application of the look-through approach without creating any additional requirements;
 - On the side of NSAs: None;
 - On the side of consumers: None.

Guideline 5 (*Data groupings*)

The Guideline clarifies that any grouping of assets into duration bands and across different credit quality steps should be prudent.

- 7.28 With regards to benefits: The Guideline provides clarity on the appropriate grouping of assets for the purpose of applying the look-through approach within the standard formula. Therefore, it ensures better policyholder protection.
- 7.29 With regards to the costs:
- On the side of the undertaking: None as it is merely a clarification on the grouping of assets for the purpose of application of the standard formula.
 - On the side of NSAs: None;
 - On the side of consumers: None.

Guideline 6 (*Data groupings and concentration risk*)

- 7.30 The guideline clarifies the application of the market risk concentration risk sub-module where data groupings are used.

- 7.31 With regards to benefits: The Guideline provides clarity on the appropriate application of the concentration risk sub-module where data groupings are used. Therefore, it helps undertakings to appropriately allow for the concentration risk.
- 7.32 With regards to the costs:
- On the side of the undertaking: None as it is merely a clarification on the application of the market risk concentration risk sub-module when data groupings are used;
 - On the side of NSAs: None;
 - On the side of consumers: None.

Guideline 7 (*Indirect exposures to catastrophe risk*)

- 7.33 The Guideline clarifies how to consider indirect catastrophe exposures.
- 7.34 The Guidelines on looking-through underwriting exposures have the general aim of ensuring that the capital charges for underlying risks are consistent irrespectively of how they may be packaged. In particular, exposures should not be excluded because they are indirect rather than direct. This Guideline is therefore only the explanation how to consider those indirect exposures to catastrophe events when calculating the Solvency Capital Requirement.
- 7.35 Additional (with respect to the baseline) costs and benefits of this Guideline can be summarised as follows.
- 7.36 With regard to costs:
- On the side of undertakings: The Guideline does not impose any costs. However, the application of the look-through approach may be burdensome as undertakings will have to assess the nature of their indirect exposures to underwriting risk. However, there is no exemption foreseen in the Directive or the Implementing Measures for this type of exposures. Hence no additional incremental compliance costs compared to the baseline are foreseen.
 - On the side of NSAs: None;
 - On the side of policy holders: None.
- 7.37 With regard to benefits:
- On the side of undertakings: Clarity about the process to be followed.
 - On the side of NSAs: Proportional, consistent and robust prudential outcomes;
 - On the side of policyholders: More adequate level of protection.

Guideline 8 (*Catastrophe bonds issued by the undertaking*)

- 7.38 The Guideline specifies that no risk-mitigating effect (or capital relief) should be taken into account where the cat bonds issued by undertakings do not meet the requirements on a risk-mitigation technique.
- 7.39 This is consistent with the treatment of other hedging instruments and therefore merely for clarification.
- 7.40 Additional (with respect to the baseline) costs and benefits of having this Guideline can be summarised as follows.

- 7.41 With regard to costs:
- On the side of undertakings: None as it clarifies the appropriate recognition of risk mitigation techniques;
 - On the side of NSAs: None;
 - On the side of policy holders: None.
- 7.42 With regard to benefits:
- On the side of undertakings: Clarity of the process to be followed.
 - On the side of NSAs: Proportional, consistent and robust prudential outcomes;
 - On the side of policyholders: More adequate level of protection.

Guideline 9 (Longevity bonds):

- 7.43 The Guideline clarifies the appropriate treatment of exposures to longevity instruments and sets out that the exposure of longevity instruments should be modelled in a manner consistent with a portfolio of life insurance contracts with the same features on aggregate.
- 7.44 Again this ensures consistency between equivalent aggregate risks in different forms by avoiding arbitrary changes to capital requirements based on the form.
- 7.45 A significant impact is therefore more likely to stem from the omission of these requirements, due to possible incentives to hold risks in particular forms; ensuring consistency minimises the impact by avoiding incentivising undertakings to take certain forms of risk which is not driven by the underlying substance.
- 7.46 Additional (with respect to the baseline) costs and benefits of having this Guideline can be summarised as follows.
- 7.47 With regard to costs:
- On the side of undertakings: Limited as it ensures consistency of treatment;
 - On the side of NSAs: None;
 - On the side of policy holders: None.
- 7.48 With regard to benefits:
- On the side of undertakings: Clarity of the process to be followed.
 - On the side of NSAs: Proportional, consistent and robust prudential outcomes;
 - On the side of policyholders: More adequate level of protection.

VI - Comparing the Options

- 7.49 EIOPA considers that the proposed Guidelines help mitigating the risk of an inconsistent approach to the look-through process. As such, they contribute to the convergence of undertakings towards appropriate standards of capital.
- 7.50 All these beneficial effects are achieved with relatively small additional costs and even with extremely significant gains in terms of the burden to undertakings and supervisory authorities that would have been otherwise necessary.

- 7.51 Policy holders will surely benefit from high standards of quality for data and the transparency assured by the set of explanations and clarifications provided by EIOPA. In particular, they give EIOPA and the NSAs a harmonised framework to supervise undertakings using the Standard Formula.
- 7.52 All in all, considering all costs and benefits, the adoption of the set of Guidelines can be considered bringing sure net benefits.

8. Application of Outwards Reinsurance to Arrangement to non-life Catastrophe Risk sub module

Introduction

This is a single paper but, as far as IA is concerned, experts in the working group decided to split the analysis into seven parts, each focusing on a specific theme:

- Specification of Events;
- Disaggregating the Gross Loss;
- Application of Outwards reinsurance;
- Re-aggregation of Net Losses;
- Documentation and Validation;
- Particular Consideration for Solos which are Part of Groups;
- Particular Considerations for the group Calculation.

For each of these seven parts, IA follows the usual standardised template. It was evaluated that this way of proceeding was particularly helpful in providing clarity and easiness to read.

8.1 Order of operation of the Guidelines

8.1.1 **Guideline 1** states the order by which undertakings should apply the successive Guidelines in order to assess their outwards reinsurance in respect of catastrophe risk. It does not involve any policy issues nor it adds any additional requirements on top of the Directive and the Implementing Measures.

8.2 Specification of the Events

I - Procedural Issues and Consultation of Interested Parties

8.2.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.

8.2.2 The focus of stakeholders contribution was on two broad issues:

- **First Issue at stake (Guidelines 2-6):** finding the option which enables harmonized and practicable approach to for the application of risk mitigation techniques in the calculation of the capital charge for non-life natural catastrophe sub-modules, and
- **Second issue at stake (Guideline 7):** finding the option which enables harmonized and practicable approach to determine loss sizes for the man-made liabilities CAT sub-module.

8.2.3 As for the first issue at stake, two different options for guidelines in this area were considered:

- Provide broad guidance to undertakings on how to define gross loss events;
- Provide very specific event definitions for undertakings.

- 8.2.4 As for the second issue at stake, three different options for guidelines in this area were considered:
- Basing size of losses on the actual limits written by the undertaking;
 - Basing losses on the largest limit;
 - Assuming remainder is generated by claims under the retention.

II - Problem Definition

- 8.2.5 As for the first issue at stake, the Implementing Measures does not always provide enough detail about the gross loss events in order to apply the firm's reinsurance arrangements; knowledge of the total gross loss amount is not enough in isolation. This situation enables complete flexibility, but also requires every undertaking to conduct significant work, and implies high risk of inconsistency across undertakings and across supervisory authorities.
- 8.2.6 As for the second issue at stake, the Implementing Measures does not provide sufficient detail on the size of losses for the liability sub-module. Without this information, the undertakings cannot calculate capital requirements because they cannot estimate the reinsurance recoveries that would be due. In the absence of these guidelines it is highly probable that undertaking would use loss sizes which generate the lowest capital requirement. Without a common methodology for determining size of losses, different practices may emerge across Member States, and undertakings would arbitrage weakening the capital requirements.

III - Objective Pursued

- 8.2.7 As for the first issue at stake, in the light of the definition of the problems identified, the objective of these Guidelines is: To enable undertakings to define gross events consistently for the relevant sub-modules which enables them to apply their risk mitigation techniques appropriately.
- 8.2.8 As for the second issue at stake, in the light of the definition of the problems in previous chapter, the objective of these Guidelines is to provide guidance on the sizes of liability losses undertakings should assume in order that they can apply their outwards reinsurance arrangements.

IV - Policy Options

- 8.2.9 ***As for the first issue at stake***, to meet the objective two policy options have been taken into consideration and discussed within the working group:
- Policy Option 1 provides broad guidance on the interpretation of the Implementing Measures;
 - Policy Option 2 provides very specific event descriptions for each of the Implementing Measures scenarios;
- 8.2.10 Both options are investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

- 8.2.11 ***As for the second issue at stake***, to meet the objective three alternative policy options have been taken into consideration and discussed within the working group:
- Policy Option 1 (actual limits) that bases size of losses on the actual limits written by the undertaking. The “remainder” produced (difference between the product of n and largest limits and the actual sizes of the n largest limits) is allocated to scale up the n largest limits proportionally so that this remainder reduced to zero;
 - Policy Option 2 (largest limit) that bases losses on the largest limit;
 - Policy Option 3 (remainder) that assumes remainder is generated by claims under the retention.
- 8.2.12 Policy Option 3 was rejected in the initial phase of the analysis, as it generated a hybrid frequency scenario, which was against the wishes of the EC. The EC rejected the liability frequency sub-module recommended by CAT SG. This is why this option is not discussed further in this paper.
- 8.2.13 Policy Options 1 and 2 are investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

First Issue at stake (Guidelines 2-6)

For the Policy Option 1, the following additional costs and benefits can be envisaged:

- 8.2.14 Additional costs:
- On the side of undertakings: small additional cost of applying the guidance compared to the baseline but this is more than offset by the savings which result from having clear principles to follow rather than each undertaking having to think through possible options by themselves;
 - On the side of Supervisors: small additional cost of applying the guidance compared to the baseline but this is more than offset by the savings which result from having clear principles to follow rather than each supervisor having to think through legitimacy or otherwise of possible options by themselves;
 - On the side of consumers: none identified.
- 8.2.15 Additional benefits:
- On the side of undertakings: consistent treatment relative to other undertakings ; significantly reduced costs compared to the baseline;
 - On the side of Supervisors: harmonised approach consistent with principles of Solvency II; significantly reduced costs compared to the baseline;
 - On the side of consumers: indirect benefits of the above for consumers.

For the Policy Option 2, the following additional costs and benefits can be envisaged:

- 8.2.16 Additional costs:
- On the side of undertakings: specific event definitions may be incompatible with company’s business, leading to inability to appropriately calculate

capital requirement. May require additional system changes to apply. Potential for specified events to benefit some undertakings compared to others, leading to competitive disadvantage;

- On the side of supervisors: time and effort to develop events, deciding how to deal with incompatibility identified in 15. Detailed event definitions may no longer be at a confidence level of 99,5 % over a 1 year period for all undertakings;
- On the side of consumers: indirect costs that arise from previous two points.

8.2.17 Additional benefits:

- On the side of undertakings: clarity and certainty on how to apply Implementing Measures scenarios, and reduced time needed to create event definitions;
- On the side of supervisors: none identified;
- On the side of consumers: none identified.

Second Issue at stake (Guideline 7)

For the Policy Option 1 (actual limits), the following additional costs and benefits can be envisaged:

8.2.18 Additional costs:

- On the side of undertakings: Costs of applying the guidance, but expected to be minimal relative to baseline;
- On the side of Supervisors: No further costs, beyond development of the guidance;
- On the side of consumers: None expected.

8.2.19 Additional benefits:

- On the side of undertakings: Clear unambiguous guidance where claim sizes reflect well what the undertaking is actually writing and hence the losses which may occur;
- On the side of Supervisors: As above, the capital requirements produced should correspond better to the undertakings actual exposures;
- On the side of consumers: Better protection due to better correspondence to actual exposure by undertakings.

For the Policy Option 2 (largest limits), the following additional costs and benefits can be envisaged:

8.2.20 Additional costs:

- On the side of undertakings: Claim sizes generated do not reflect well what the undertaking is actually writing (this is especially the case if the largest limit is materially larger than any other limit the undertaking has taken on). The undertaking may “over purchase” reinsurance as a result in an aim to minimise capital requirements, and this may leave them exposed in other areas;
- On the side of Supervisors: As above, the guidelines developed in this way could lead to unintended consequences;
- On the side of consumers: they may not be as well protected as they should be.

- 8.2.21 Additional benefits:
- On the side of undertakings: this option may be marginally easier to apply than Option 1.
 - On the side of Supervisors: None expected;
 - On the side of consumers: None expected.

VI - Comparing the Options

8.2.22 The following table summarises the analysis and provides an at-a-glance comparison between options for the first issue at stake, highlighting the reasons at the basis of the selection of Option 1:

Objective: To enable undertakings to define gross events consistently for the relevant sub-modules which enables them to apply their risk mitigation techniques appropriately (Guidelines 2 – 6)		
Policy Option 1 Provide broad guidance on the interpretation of the Implementing Measures scenarios	Policy Option 2 Provide very specific event descriptions for each of the Implementing Measures scenarios	<i>Final choice and justification</i> Policy Option 1 – Provide broad guidance on the interpretation of the Implementing Measures scenarios
Provides appropriate methodologies along with sufficient flexibility for each undertaking to define events appropriately for their specific business and thus apply risk mitigation techniques	Resolves the lack of ambiguity. However, specific event descriptions may be incompatible with undertaking's business and mean that their risk mitigation techniques cannot be applied appropriately	Policy Option 1 strikes the balance between no guidance at all and highly specific event descriptions which may not be appropriate for everyone

8.2.23 As for the second issue at stake, Policy Option 1 was selected on the basis of the analysis above. This Option 1 better reflects exposure of undertakings and therefore contributes to better consumer protection. The costs for supervisors are only for development of guidance and therefore marginal. Although the Option 2 may be marginally easier to apply than Option 1, the benefits of Option 1 clearly outweigh this.

8.3 Disaggregating the Gross Loss

I - Procedural Issues and Consultation of Interested Parties

- 8.3.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.3.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.3.3 One option for guidelines in this area was considered: Provide specific methodologies, whilst rejecting those which may lead to misstate the SCR.

II - Problem Definition

- 8.3.4 The standard formula framework provides the net 1-in-200 year catastrophe charge. However, this is not the same as the gross 1-in-200 year catastrophe charge netted down, which is what is theoretically required by the Solvency II capital requirements framework, and requires the application of risk mitigation techniques.
- 8.3.5 There are instances where losses arising from scenarios are insufficiently granular to allow appropriate application of the risk mitigation techniques.
- 8.3.6 The Implementing Measures text does not specify the methods for disaggregating scenarios. This situation enables complete flexibility, but also requires every undertaking to conduct significant work, and high risk of inconsistency across undertakings and across supervisory authorities.

III - Objective Pursued

- 8.3.7 In the light of the definition of the problems, the objective of these guidelines is: To ensure undertakings disaggregate the gross loss to individual countries or other components in a consistent manner for all possible scenarios.

IV - Policy Options

- 8.3.8 To meet the above objectives, the following single policy option has been taken into consideration and discussed within the working group: provide specific methodologies, whilst rejecting those which may lead to misstate the SCR.
- 8.3.9 This option is investigated in comparison to the baseline of not issuing any EIOPA guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the Policy Option 1, the following additional costs and benefits can be envisaged:

8.3.10 Additional costs:

- On the side of undertakings: small additional cost to apply the guidance and some costs due to limiting of flexibility of methods which can be applied, there may be alternative methods which are more suitable for specific risk profiles than the particular methods specified in the guidance;
- On the side of Supervisors: as above;
- On the side of consumers: indirect impact from previous points.

8.3.11 Additional benefits:

- On the side of undertakings: consistent treatment relative to other undertakings, ensuring a level playing field;
- On the side of Supervisors: harmonised approach consistent with principles of Solvency II;
- On the side of consumers: indirect benefits of the above for consumers.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance description of costs and advantages of applying Policy Option 1:

Objective – To ensure undertakings disaggregate events in a consistent manner for the gross loss (Guidelines 8 - 14)	
Policy Option 1 Provide specific methodologies, whilst rejecting those which may lead to misstate the SCR	<i>Final Choice and justification:</i> Policy Option 1 is the only viable option
Approach ensures minimum burden whilst also ensuring consistency between undertakings and across supervisory authorities.	Only technically viable option. Provides minimum burden to the undertaking, yet also ensures consistency across different entities and supervisors.

8.4 Application of Outwards Reinsurance

I - Procedural Issues and Consultation of Interested Parties

- 8.4.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.4.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.4.3 Two different options for guidelines in this area were considered:
- Specify how risk mitigation is to be applied at specific levels of the hierarchy;
 - Specify how risk mitigation is to be applied to specific levels of the hierarchy and all subsequent levels of calculation.

II - Problem Definition

- 8.4.4 The Implementing Measures text does not provide detail on how the undertaking should apply its outwards reinsurance arrangements. This situation enables complete flexibility, but also requires every undertaking to conduct significant work, and high risk of inconsistency across undertakings and across supervisory authorities.

III - Objective Pursued

- 8.4.5 Objectives pursued are threefold:
- Provide details specific to the application of different reinsurance programme types and allow for consideration of reinstatement premiums and other impacts on an undertaking's basic own funds;
 - To ensure consistency of application of reinsurance;
 - To avoid double counting of reinsurance.

IV - Policy Options

- 8.4.6 To meet the above objectives, the following policy options have been taken into consideration and discussed within the working group:
- Policy Option 1: Specify how risk mitigation is to be applied at specific levels of the hierarchy;
 - Policy Option 2: Specify how risk mitigation is to be applied to specific levels of the hierarchy and all subsequent levels of calculation;
 - Both options are investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the Policy Option 1, the following additional costs and benefits can be envisaged:

8.4.7 Additional costs:

- On the side of undertakings: small additional costs relative to baseline as a result of applying the risk mitigation methods specified. This option also requires each undertaking to work out for themselves how to apply outwards reinsurance through all subsequent calculations (as this would not be specified in the guidance), requiring redundant work;
- On the side of Supervisors: may result in inconsistency and inaccurate calculations on the impact of outwards reinsurance on the SCR;
- On the side of consumers: indirect costs of previous two points.

8.4.8 Additional benefits:

- On the side of undertakings: some additional benefit from specifying how to apply the risk mitigation at specific levels, but do not get the full benefit of Option 2;
- On the side of Supervisors: as above;
- On the side of consumers: indirect benefits from above.

For the Policy Option 2, the following additional costs and benefits can be envisaged:

8.4.9 Additional costs:

- On the side of undertakings: small additional costs from application of the methodology, but outweighed by benefits below ;
- On the side of Supervisors: none identified;
- On the side of consumers: eventual indirect costs deriving from additional costs for undertakings.

8.4.10 Additional benefits:

- On the side of undertakings: Allows undertakings to most accurately reflect the application of their outwards reinsurance throughout their entire SCR calculations;
- On the side of Supervisors: Generates the most accurate view of the impact of each undertaking's outwards reinsurance arrangements, and also maintains consistency between undertakings and across supervisory authorities;
- On the side of consumers: Indirect benefits of previous two points.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance comparison between options:

Provide specific guidelines on the application of different reinsurance programme types and allow for consideration of reinstatement premiums and other impacts on an undertaking's basic own funds, ensuring consistency whilst also preventing against double-counting (Guidelines 15 - 26)		
Policy Option 1 Specify how risk mitigation techniques are to be applied to individual scenarios at specific levels of the hierarchy	Policy Option 2 Specify how risk mitigation techniques are to be applied to specific levels of the hierarchy and all subsequent levels of calculation	<i>Final choice and justification</i> Policy Option 2
Does not reflect the true economics of the arrangement, puts more burden on each undertaking to work out how to apply risk mitigation techniques throughout the calculations.	Provides guidance on all stages of the calculation, reducing the burden on undertakings and the risk they may misstate the impact of their risk mitigation techniques.	Strikes the best balance between ensuring consistency and accuracy in the application of outwards reinsurance, without over-burdening each undertaking.

8.5 Re-aggregation of Net Losses

I - Procedural Issues and Consultation of Interested Parties

- 8.5.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.5.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.5.3 Two different options for guidelines in this area were considered:
- Provide two methods that undertakings can use as appropriate for their specific business structure;
 - Specify a single permissible method for re-aggregation of net losses.

II - Problem Definition

- 8.5.4 Undertakings applying Section 3 of the Reinsurance Guidelines will have calculated their net losses. The output after application of Section 3 may be at various levels dependent on the specificities of their reinsurance programme. Some of the reinsurance arrangements may be specific to the sub-module and level such that the reinsurance recoveries arising can be estimated independently of other sub-modules and levels on the direct gross loss (pre diversification). This will require some method of re-aggregation to derive the undertaking's SCR for catastrophe risk.
- 8.5.5 However, the Implementing Measures text does not specify how to re-aggregate the net losses to derive the undertakings catastrophe SCR.
- 8.5.6 Without EIOPA intervention, all undertakings have to conduct significant work to generate re-aggregation methodology, leading to redundant work and possible inconsistency. In the absence of any guidance undertakings may end up either diversify twice or not at all.

III - Objective Pursued

- 8.5.7 In the light of the identified problems, the objectives of these Guidelines are to provide guidance on the re-aggregation of the net losses to derive the SCR for the undertaking (Guideline 27).

IV - Policy Options

- 8.5.8 To meet the objective two policy options have been taken into consideration and discussed within the working group:
- Policy Option 1: Provide two methods that can be used for re-aggregation of net losses, allowing the undertaking to apply which is most appropriate, according to their specific business.
 - Policy Option 2: Specify a single permissible method for re-aggregation of net losses.
 - Both options are investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the Policy Option n1, the following additional costs and benefits can be envisaged:

- 8.5.9 Additional costs:
- On the side of undertakings: there may be a cost of having the potential re-aggregation methodologies restricted, but we do not anticipate that there is a wide spectrum of alternative reasonable methods available so this cost is expected to be small;
 - On the side of Supervisors: none identified.
 - On the side of consumers: none identified.
- 8.5.10 Additional benefits:
- On the side of undertakings: consistency in approach between undertakings, ensuring a level playing field. Confidence in methodology with the possibility of benefiting from a controlled flexibility (there are two possible choices and undertaking can chose the most suitable for its specificities);
 - On the side of Supervisors: consistency across supervisory authorities, and confidence that SCR calculations are correct;
 - On the side of consumers: indirect benefits of previous two points.

For the Policy Option n. 2, the following additional costs and benefits can be envisaged:

- 8.5.11 Additional costs:
- On the side of undertakings: the specified approach may not be appropriate for the undertaking's specific business, leading to an incorrect application of risk mitigation techniques, either over-estimating or under-estimating the SCR.
 - On the side of Supervisors: implications of previous point;
 - On the side of consumers: indirect cost of previous two points.
- 8.5.12 Additional benefits:
- On the side of undertakings: single specified approach means there full guidance and no further work is needed to choose the methodology;
 - On the side of Supervisors: none identified;
 - On the side of consumers: none identified.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance comparison between options:

Objective: how to re-aggregate the net losses to derive the undertakings catastrophe SCR (Guideline 27)		
<p>Policy Option 1 Provide 2 methods that can be used for re-aggregation of net losses, allowing the undertaking to apply which is most appropriate</p>	<p>Policy Option 2 Specify a single permissible method for re-aggregation of net losses</p>	<p><i>Final choice and justification</i> Policy Option 1</p>
<p>Methodologies provided will prevent against undertaking's miscalculation of re-aggregation, but retains some flexibility so that undertakings can apply what's appropriate.</p>	<p>Full certainty about what to do, but single approach may not reflect some undertaking's specific business, leading to a misapplication of risk mitigation techniques and miscalculation of the SCR.</p>	<p>Strikes the best balance between ensuring consistency, providing viable methodology, whilst also allowing undertaking's to reflect the specifics of their business.</p>

8.6 Documentation and Validation

I - Procedural Issues and Consultation of Interested Parties

- 8.6.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.6.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.6.3 Two different options for guidelines in this area were considered:
- Specify the level of detailed required in the documentation;
 - Provide templates.

II - Problem Definition

- 8.6.4 The output from the various stages of applying reinsurance should be documented, but no documentation templates or guidelines are provided by the Implementing Measures.

III -Objective Pursued

- 8.6.5 In the light of the defined problem, the objective of these guidelines is to: To define an appropriate level of documentation which is not too burdensome in order that the supervisor can properly review the undertakings application of reinsurance.

IV -Policy Options

- 8.6.6 To meet the objective two policy options have been taken into consideration and discussed within the working group:
- Policy Option 1: Specify the level of detail required in the documentation;
 - Policy Option 2: Specify a reporting template;
 - Both options are investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the Policy Option 1, the following additional costs and benefits can be envisaged:

8.6.7 Additional costs:

- On the side of undertakings: no material costs identified, documenting will allow the undertaking to check whether the implied results from their calculations are correct;
- On the side of Supervisors: none identified;
- On the side of consumers: none identified.

8.6.8 Additional benefits:

- On the side of undertakings: allows undertakings the ability to describe the specific and unique nature of their calculations, whilst ensuring that they also provide sufficient detail to their supervisor. Interactions between undertakings and Supervisors are streamlined;
- On the side of Supervisors: ensures that undertakings provide sufficient detail in their documentation for supervisors to conduct their assessment without needing to spend additional time with the undertaking. Ensures consistency across authorities;
- On the side of consumers: indirect benefits deriving from previous points.

For the Policy Option 2, the following additional costs and benefits can be envisaged:

8.6.9 Additional costs:

- On the side of undertakings: a reporting template will not be able to reflect the wide variety of reinsurance programmes that exist, meaning that an undertaking could not fully guarantee that their reporting is appropriate given the nature of their business and reinsurance arrangements.
- On the side of Supervisors: supervisors will not be able to understand the specific details of each undertaking's unique business and calculations;
- On the side of consumers: indirect costs of the above two points.

8.6.10 Additional benefits:

- On the side of undertakings: small additional benefit of not needing to think through the format required for an appropriate documentation;
- On the side of Supervisors: some benefits from harmonisation, but would not allow the supervisor to understand the specificities of the business;
- On the side of consumers: indirect benefits of the above two points.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance comparison between alternative options:

Objective: To articulate the requirements on expected level of detail required in the documentation (Guidelines 28 – 30)		
Policy Option 1 Specify the level of detail required in the documentation	Policy Option 2 Specify a reporting template	<i>Final choice and justification</i> Policy Option 1
Allows undertakings the ability to document the specific nature of their business, whilst also ensuring they provide enough detail to supervisors, and ensure consistency	Not possible to reflect each undertaking's specific business and calculations by using a template, given the variety in reinsurance programmes	Provides the best balance between ensuring undertakings provide enough detail in their documentation, but can also reflect their specific business accurately

8.7 Particular Considerations for Solos which are Part of Groups

I - Procedural Issues and Consultation of Interested Parties

- 8.7.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.7.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.7.3 One alternative option for guidelines in this area were considered: Provide guidance to solo undertakings which are part of groups on how to account for internal and group aggregate reinsurance or other risk mitigation techniques.

II - Problem Definition

- 8.7.4 Solo undertakings which are part of groups may have internal, group or aggregate reinsurance or other risk mitigation techniques they need to take into account in their calculation of their SCR, which are not covered by other guidelines in this area.
- 8.7.5 The sequence of calculations must be applied correctly in these cases in order to accurately understand the solo undertakings capital requirement and ensure they do not purchase insufficient coverage or too much.
- 8.7.6 Without Eiopa interventions, full flexibility for undertakings will result in lack of consistency between undertakings and across supervisors, and some risk of misapplication of internal and group reinsurance and other risk mitigation techniques.

III - Objective Pursued

- 8.7.7 In the light of the problem defined, the objective of these guidelines are: To ensure solo undertakings that are part of a group account correctly for internal, group, aggregate or other reinsurance/risk mitigation techniques in their capital calculations.

IV - Policy Options

- 8.7.8 To meet the above objective, the following policy option has been taken into consideration and discussed within the working group:
- Policy Option 1: Provide reasonable methods for solo undertakings across all possible group and internal reinsurance structures.
 - This option is investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the aforementioned Policy Option 1, the following additional costs and benefits can be envisaged:

- 8.7.9 Additional costs:
On the side of undertakings: methods specified are not expected to lead to material additional costs to implement;
- On the side of Supervisors: none identified;
 - On the side of consumers: none identified.
- 8.7.10 Additional benefits:
- On the side of undertakings: Full certainty and clarity on how to apply internal and group reinsurance arrangements across a variety of scenarios impacting either just the solo undertaking or multiple entities within the groups;
 - On the side of Supervisors: Consistency in approach across undertakings, confidence in approaches being applied;
 - On the side of consumers: Indirect benefits originating in the previous two points.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance description of costs and advantages of applying Option 1:

Objective – To ensure solo undertakings that are part of a group account correctly for internal, group, aggregate or other reinsurance/risk mitigation techniques in their capital calculations (Guideline 31 - 33)	
Policy Option 1 Provide reasonable methods for solo undertakings across all possible group and internal reinsurance structures	<i>Final Choice and justification:</i> Policy Option 1 is the most viable option
Provides undertakings with sound methodologies across all scenarios of events impacting the solo and/or the group, and different types of internal and group reinsurance or other risk mitigation techniques that may exist, catering for all possible situations, yet also ensuring consistency across undertakings and supervisory authorities.	Provides minimum burden to the undertaking, ensures that complex internal and group reinsurance and other risk mitigation techniques are applied in the capital calculation, ensures also consistency across different entities and supervisors.

8.8 Particular Considerations for the Group Calculation

I - Procedural Issues and Consultation of Interested Parties

- 8.8.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.8.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.8.3 A single alternative option for guidelines in this area was considered: Provide guidance on how to account for possible interactions internal and external reinsurance or other risk mitigation techniques in their capital requirements at the group level

II - Problem Definition

- 8.8.4 Internal reinsurance within a group may exist which insures to the benefit of a solo undertaking's external reinsurance. In a group calculation, the impact of any internal participation on reinsurance contracts to the reinsured and reinsuring undertakings needs to be accounted for in the capital calculations.
- 8.8.5 There would be a risk that interaction between internal and external reinsurance or other risk mitigation techniques is not acceptable to the Supervisor, requiring rework.

III - Objective Pursued

- 8.8.6 In the light of the problem defined, the objective of these guidelines is: To ensure that all undertakings within a group take into account the interaction between any internal group and external reinsurance arrangements or other risk mitigation techniques and calculate their capital requirement appropriately.

IV - Policy Options

- 8.8.7 To meet the above objective, the following policy option has been taken into consideration and discussed within the working group:
- Policy Option n. 1: Provide guidance on how to specifically consider internal reinsurance or other risk mitigation techniques, and how to account for the interaction with outwards reinsurance and other risk mitigation techniques;
 - This option is investigated in comparison to the baseline of not issuing any EIOPA Guidelines. In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

For the Policy Option n. 1, the following additional costs and benefits can be envisaged:

8.8.8 Additional costs:

- On the side of undertakings: the guidance is specifying the methodology which undertakings should apply, there is no alternative correct way to do this. Hence the guidance is not leading to additional costs;
- On the side of Supervisors: as above;
- On the side of consumers: none identified.

8.8.9 Additional benefits:

- On the side of undertakings: Guidance helps avoid mistakes, additional costs, and ensures consistency with other undertakings and groups;
- On the side of Supervisors: Guidance helps ensure consistency and harmonisation across supervisory authorities;
- On the side of consumers: Indirect benefits originating in the two previous points.

VI - Comparing the Options

The following table summarises the analysis and provides an at-a-glance view on the costs and advantages of Eiopa intervention:

Objective – To ensure that all undertakings within a group take into account the interaction between any internal group and external reinsurance arrangements or other risk mitigation techniques and calculate their capital requirement appropriately (Guideline 40)	
Policy Option 1 Provide guidance on how to specifically consider internal reinsurance or other risk mitigation techniques, and how to account for the interaction with the group outwards reinsurance	<i>Final Choice and justification:</i> Policy Option 1 is the most viable option
It provides clarifications on what do to, and ensures consistency between undertakings, and harmonisation between supervisory authorities.	Provides minimum burden to the undertaking, yet also ensures consistency across different entities and supervisors.

8.9 Allocation of Insurance Policies to the Liability Risk Group for the man-made Liability CAT Risk sub-module

I - Procedural Issues and Consultation of Interested Parties

- 8.9.1 The IA was drafted after the paper was approved by FinReq and in principle approved by the EC. Stakeholders were not formally pre-consulted, however they were involved in the development of the paper as observers in the CAT subgroup of FinReq.
- 8.9.2 The focus of stakeholders' contribution was on finding the option which enables harmonized and practicable approach to calculate capital charge for non-life natural catastrophe sub-modules.
- 8.9.3 Two different options for allocating liability products to different risk categories have been considered in Guidelines 1 to 5: a) principle based or b) specifying a mapping for all products written in the EU. The latter was determined not feasible and this IA report gives evidence of the rationales behind this choice.
- 8.9.4 Moreover, the IA explores the utility of giving clear and unique guidance about when and how to unbundle products between different risk groups as provided in Guideline 6.

II - Problem Definition

- 8.9.5 The Implementing Measures does not provide sufficient detail on which products will fall into the specific liability risk groups. Without this information, the undertakings cannot calculate capital requirements.
- 8.9.6 In the absence of these guidelines it is highly probable that undertaking would ask to National Supervisory Authorities information about how to categorize products.
- 8.9.7 Without a common methodology for categorizing products, different practices may emerge across Member States, causing dis-homogeneity, weakening supervisory capacity, and also preventing the development of a European level playing field.
- 8.9.8 To evaluate additional effects of these guidelines, the benchmark is represented by previous levels of legislation, included the draft version of the Implementing Technical Measures. The detailed definition of the benchmark is provided in the Introduction.

III - Objective Pursued

- 8.9.10 In the light of the definition of the problems in previous chapter, the objectives of these guidelines are two:
- Objective 1 - Providing clear and unique guidance to undertakings in allocating their liability products to the different risk categories in order to compute their gross liability charges (**Guidelines 34-38**);
 - Objective 2 - Providing clear and unique guidance about when and how to unbundle products between different risk groups (**Guideline 39**).

IV - Policy Options

- 8.9.11 To meet the first objective two policy options have been taken into consideration and discussed within the working group:
- Policy Option 1 (principles approach) - Providing principles to determine which types of liability products fall into which liability risk groups;
 - Policy Option 2 (listing approach) – In alternative, developing and maintaining a list of all products written across the EU.
- 8.9.12 To meet the second objective the following option has been taken into consideration and discussed within the working group:
- Policy Option 1 (principles approach) - Providing principles about when and how to unbundle between risk groups.

V - Analysis of Impact

First Objective

For the Policy Option 1 (principles approach), the following additional costs and benefits can be envisaged:

- 8.9.13 Additional costs:
- On the side of undertakings: Undertakings would need to use the principles to categorise the policies they have written;
 - On the side of Supervisors: Costs in drafting suitable principles, and ensuring undertakings have categorised policies correctly. The first cost category is limited because it is only done at the beginning and is not recurrent. The second cost category is expected to be limited, as this would be performed on exceptions basis (e.g. for strange or unusual products). In most cases the categorisations are clear;
 - On the side of consumers: No expected costs.
- 8.9.14 Additional benefits:
- On the side of undertakings: Undertakings most well placed to categorise their policies and a principle based approach will ensure that delay in potential categorisation of a new product is minimised. Under a listing approach, this would need to be discussed and agreed by EIOPA and/or EC and there would be a period where no categorisation is available for the product written;
 - On the side of Supervisors: Minimal costs to supervisors; supervisors can focus effort in challenging the categorisation of strange or unusual products;
 - On the side of consumers: No expected benefits.

For the Policy Option 2 (listing approach), the following additional costs and benefits can be envisaged:

8.9.15 Additional costs:

- On the side of undertakings: Direct costs limited; indirect costs potentially high as product innovation could mean that categorisations are no longer appropriate / not available.
- On the side of Supervisors: Supervisors would need to maintain separate lists for each specific territory and keep abreast of detailed market developments; it would incur significant costs to keep lists up to date. Additionally, it is unlikely that lists could be developed to capture every product variation written in the complex markets, and where a product needs to be unbundled a unique mapping to category is not possible;
- On the side of consumers: No expected costs.

8.9.16 Additional benefits:

- On the side of undertakings: Relatively easy to apply, apart from the problems alluded to above;
- On the side of Supervisors: No further checking is required;
- On the side of consumers: No expected benefits.

Second Objective

For the Policy Option 1 (principles approach), the following additional costs and benefits can be envisaged:

8.9.17 Additional costs:

- On the side of undertakings: Undertakings would need to unbundle following the principles in the guidelines;
- On the side of Supervisors: No additional costs beyond development of guidelines;
- On the side of consumers: No expected costs.

8.9.18 Additional benefits:

- On the side of undertakings: A principles based approach means that undertakings can unbundle products and hence capital charges are risk reflective;
- On the side of Supervisors: As above;
- On the side of consumers: No expected benefits.

VI - Comparing the Options

8.9.19 For First Objective the Policy Option 1 (principles approach) is less costly since it requires minimal costs for drafting suitable principles for mapping the liability products. Furthermore, the costs for supervisors only realize at the beginning and then they can focus their efforts in challenging the categorisation of strange or unusual products.

8.9.20 Undertakings are used to categorize their products and also for them the costs realize at the beginning and afterwards only when new products are introduced. The Option 2 is more costly since the list has to be maintained all the time whenever new products are developed and undertakings could have high indirect costs as product innovation could mean that

categorisations are no longer appropriate / not available. Given all the arguments above, the option is chosen.

- 8.9.21 To achieve the Second Objective only a principle based approach is possible and concretely viable; therefore only one option is developed.

9. Application of the Life Underwriting Risk Module

- 9.1. The Guidelines on the application of the life underwriting risk module aim at providing clarification on how to calculate the stresses to mortality, longevity, disability-morbidity inception and disability-morbidity recovery rates in the life underwriting risk module. They clarify in particular which transition rates need to be shocked in accordance with Article 139 of the Implementing Measures (Art. 105(3) of Directive 2009/138/EC) for a contract that allows for multiple states of disability when calculating technical provisions under stressed conditions.

I - Procedural Issues and Consultation of Interested Parties

- 9.2. The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements from different national competent authorities and EIOPA.
- 9.3. Selected stakeholders were pre-consulted in the preparation of the Guidelines.
- 9.4. When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation, please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".

II - Problem Definition

- 9.5. While it is straightforward to apply Article 139 of the Implementing Measures (Art. 105(3) of Solvency II) when there is only one state of disability-morbidity, it is not clear which transition rates need to be shocked for a contract that allows for multiple states of disability.
- 9.6. Without EIOPA intervention the legislative framework would remain open to multiple interpretations, creating uncertainty, weakening the European level playing field and making supervisory activities more complicate with possible repercussions also on consumers.

III - Objective Pursued

- 9.7. The goal of these Guidelines is to provide clarifications and guidance in the calculation of the disability-morbidity risk capital requirements to facilitate the implementation and the convergent application of Solvency II.
- 9.8. In particular, the objective is to specify how to apply Article 139 of the Implementing Measures (Article 105(3) of Solvency II) when insurance contracts allow for multiple states of disability.
- 9.9. When analysing the impact of policies, the methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered.

9.10. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention.

9.11. For the analysis of the potential related costs and benefits of the proposed Guidelines EIOPA has applied as a baseline previous levels of legislation. A more detailed description of the characteristics of the baseline is provided in the Introduction.

IV - Policy Options

9.12. The IA focuses on Guideline 5 as it is the only that involves a policy choice. The rest of the Guidelines (1-4) merely clarify and explain. They are considered to add no new requirements on top of the Directive and the Implementing Measures and therefore to create no additional costs.

9.13. The following options were explored as alternatives to the baseline during the drafting of Guideline 5:

Issue 1: Rates to which shocks should be applied in the case of multi-status guarantees

9.14. **Option 1:** For each policyholder for which a technical provision is calculated, all rates of transition from one status to a more severe or less severe one should be shocked as specified in paragraphs (a) to (c) of Article 139 of the Implementing Measures, irrespective of the current status of the policyholder for which a technical provision is calculated;

9.15. **Option 2:** For each policyholder for which a technical provision is calculated, only the transition rates from the current status of the policyholder to other statuses should be shocked according to Article 139 (a) to (c) of the Implementing Measures.

Issue 2: How to ensure that transition rates from one state to others still add up to 1 after applying a shock (mathematical consistency)

9.16. **Option 1:** Let undertakings adjust all rates that are not directly shocked.

9.17. **Option 2:** Adjust only persistency rates.

9.18. Without further clarification, the current legislative framework would leave too much flexibility to undertakings in interpreting Article 139 of the Implementing Measures (Article 105(3) of Solvency II).

V - Analysis of Impact

9.19. With respect to the baseline it is possible to identify the following additional costs and benefits for each of the two options:

Issue 1: Rates to which shocks should be applied in the case of multi-status guarantees

9.20. **Option 1** is consistent with the application of stresses for the other biometric risks envisaged in the standard formula and results in a higher capital

requirement than Option 2. It might therefore result in a lower supply of multi-status guarantees.

9.21. **Option 2** leads to after-shock transition rates which depend on the current status of the policyholder for which a technical provision is calculated. If there are for example the statuses "disabled" and "heavily disabled", the transition rates between the two statuses would be different for persons who are currently or in the future "disabled", other things being equal. This can be considered as a minor technical inconsistency.

Issue 2: How to ensure that transition rates from one state to others still add up to 1 after applying a shock (mathematical consistency)

9.22. **Option 1:** undertakings can adjust the rates, which are the easiest to modify. They can adapt the adjustment to their specific model.

9.23. **Option 2:** lets undertakings benefit from a unique, simple and consistent methodology, whatever the transition matrix considered: when applying the shocks both to incidence rates and to recovery rates, persistency rates are never directly shocked and thus can be in both cases adjusted to ensure that the transition rates from one state to others still add up to 1.

VI - Comparing the Options

Issue 1: Rates to which shocks should be applied in the case of multi-status guarantees

9.24. On the basis of the effects identified in the previous section option 1 was preferred on the basis of convergence and robustness of risk management and Solvency Capital Requirement calculation.

9.25. The main advantage of Option 1 is the higher consistency and harmonization in the application of shocks in the standard formula.

9.26. Moreover, this option would be much easier for undertakings to implement compared with Option 2.

Issue 2: How to ensure that transition rates from one state to others still add up to 1 after applying a shock (mathematical consistency)

9.27. Taking account of the effects identified in the previous section Option 2 was preferred on the basis of convergence and robustness of risk management and Solvency Capital Requirement calculation.

9.28. The main advantage of Option 2 is that it can be applied when shocking both incidence and recovery rates.

9.29. Moreover, Option 2 avoids mortality rates to be adjusted, which is consistent with the fact that they are not shocked in the disability-morbidity sub-module (mortality risk is already taken into account in the mortality sub-module, as provided by Article 137 of the Implementing Measures).

9.30. Moreover, Option 1 would have given the possibility to undertakings to adjust recovery rates, when shocking incidence rates, which would have underestimated the economic value of post-shock liabilities.

10. Application of the Health Catastrophe Risk Sub-Module

I - Procedural Issues and Consultation of Interested Parties

- 10.1 The "Guidelines on the application of the health catastrophe risk sub-module" have been developed by experts from national supervisory authorities and the health insurance industry initially under the remit of the CAT Task Force (now known as the CAT subgroup) and then the SCR subgroup of FinReq.
- 10.2 Two phases of development can be identified:
- In a first phase, issues for clarification were identified by the experts of the CAT Task Force (TF) and a first set of Guidelines has been drafted. This first set was pre-consulted with major European stakeholders. Its content was also presented to representatives of the Austrian and Slovakian industries, who provided remarks and questions;
 - on the basis of the received input, some additional issues for clarification were identified and a revised set of guidelines was developed by the CAT TF.
- 10.3 The result of those two drafting phases was then submitted to the European Commission for a legal check. The comments received were addressed through incremental changes.
- 10.4 Therefore, the Guidelines are the result of a process involving:
- Experts from NSAs and the industry;
 - EIOPA staff;
 - Operatives from industry;
 - The European Commission.

II - Problem Definition

- 10.5 The Guidelines are not intended to solve a specific problem observed in the market. They provide clarification on the requirements in the existing legislation.

III - Objective Pursued

- 10.6 The aim of the Guidelines is to provide additional clarity and practical hints to insurance and reinsurance undertakings regarding the calculation of capital charges for health catastrophe risks.

IV - Policy Options

- 10.7 These Guidelines do not involve any policy options.
- 10.8 They were developed on a consensual basis. Their only aim is to provide clarification and thus avoid misinterpretations and prevent costs for ex-post coordination and re-adjustments.

10.9 The merits of adopting the Guidelines are assessed relative to the baseline of not issuing any Guidelines. This is in line with the baseline provided in the Introduction.

V - Analysis of impacts

10.10 The Guidelines are considered not to introduce any new requirements and to have no material impact compared to the baseline of the existing legislation. They satisfy a need for clarification and guidance in the understanding of existing levels of legislation.

VI - Comparing the Options

10.11 On balance the Guidelines have a net beneficial effect. They do not introduce any new requirements or costs but at the same time avoid ambiguity in the interpretation of the Solvency II framework. This allows undertakings and NSAs to save costs for later revisions and adjustments.

10.12 The harmonised application of the Solvency II requirements is important to ensure a level playing field across Europe.

10.13 Consumers benefit from a more transparent and competitive market.

11. Treatment of Market and Counterparty Risk Exposures in the Standard Formula

I - Procedural Issues and Consultation of Interested Parties

- 11.14 The "Guidelines on the treatment of market and counterparty risk exposures in the standard formula" aim at providing clarification on how to treat a number of instruments in the market and counterparty default risk modules of the standard formula.
- 11.15 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements from different national competent authorities and EIOPA.
- 11.16 Stakeholders were pre-consulted in the preparation of the Guidelines.
- 11.17 Specific attention has been given to proportionality issues. When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation, please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".

II - Problem Definition

- 11.18 It has been noticed that undertakings are not fully certain how to apply the market and counterparty risk modules in certain instances.
- 11.19 Without EIOPA intervention different readings and interpretations of the Directive and the Implementing Measures could emerge, giving rise to uncertainty and slowing convergence of practices across Member States. A possible result would be additional costs for undertakings to comply with the requirements and for supervisory authorities to verify this.

III - Objective Pursued

- 11.20 The Guidelines aim at facilitating convergence of practices across Member States and supporting undertakings in the calculation of their capital requirements for market and counterparty default risk.
- 11.21 In particular, the aim is twofold:
- to support the consistent interpretation of the Directive and the Implementing Measures and thus contributing towards harmonisation across Member States.
 - to increase consistency and convergence of professional practices in the application of the market and counterparty default risk module of the standard formula for all types and sizes of undertakings.
- 11.22 When analysing the impact of these Guidelines, the methodology foresees the use of a baseline scenario as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The baseline scenario allows assessing how the current situation would evolve without additional regulatory intervention.

11.23 For the analysis of the potential related costs and benefits of the proposed Guidelines, EIOPA has applied as a baseline the existing levels of legislation, i.e. the requirements set out in the Directive and the Implementing Measures. This is in line with the baseline provided in the introduction.

IV - Policy Options

11.24 To ensure a harmonised interpretation and coherent application of existing legislation EIOPA considered the adoption of the Guidelines set out below.

11.25 Each guideline has a purely explanatory and clarifying character. Its effects in terms of benefits and costs are evaluated relative to a scenario (the baseline) in which EIOPA does not issue any Guideline to complement the existing legislative framework.

11.26 Therefore, for each Guideline the decision is whether to adopt it or not.

V - Analysis of Impact

11.27 Relative to the baseline it is possible to identify the following benefits and costs for the introduction of each of the Guidelines.

11.28 **Guideline 1** (Employee benefits) provides clarification on how undertakings should treat employee benefits, whether or not outsourced in a sponsor underwritten IORP, in the standard formula.

11.29 With regard to benefits, a clarification on such an important issue is beneficial for every party involved (undertakings, NSAs and consumers).

11.30 With regard to costs:

- On the side of undertakings: not material because it is merely a clarification without the creation of any additional duty or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.31 **Guideline 2** (*Influence of call options on duration*) reminds undertakings that the likelihood of debt instruments with call options to be called may vary with the circumstances and that they should reflect this in the determination of duration. Insurers should consider the dynamic influences of changes anyway but the guideline makes this explicit.

11.32 With regard to benefits: the guideline improves the clarity and unambiguity of the regulatory framework.

11.33 It emphasizes the importance for undertakings to monitor the probability of calls with changes in market conditions. This is beneficial both for undertakings as well as for NSAs. A sounder, more prudent and transparent system is of course also beneficial for consumers.

11.34 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;

- On the side of consumers: None.

11.35 **Guideline 3** (*Average duration for the duration-based equity sub-module*) clarifies how the term duration in Article 304 (1)(b)(iii) of Solvency II is to be interpreted.

11.36 With regard to benefits, they arise from the clarity and consistency of the treatment. Beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.37 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.38 **Guideline 4** (*Interest rate risk sub-module*) clarifies how the interest rate risk sub-module should be applied to interest rate sensitive assets and liabilities. More detail is provided on the application of stresses to assets for which market values are available.

11.39 With regard to benefits, they arise from the clarity and consistency of the treatment. The beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.40 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.41 **Guideline 5** (*Investments with equity and debt instrument characteristics*) clarifies the treatment of investment instruments with equity and debt features within the standard formula. For the risk-adequate attribution of these investments to relevant risk sub-modules of the standard formula the possibility of unbundling as well as the question which features dominate in an economic sense are crucial.

11.42 With regard to benefits, they arise from the clarity and consistency of the treatment. The beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.43 With regard to costs:

- On the side of undertakings: not material because it is merely a clarification without the creation of any additional obligation or requirement;
- on the side of NSAs: none;
- on the side of consumers: none.

11.44 **Guideline 6** (*Short equity positions*) clarifies how undertakings should treat short equity exposures in the standard formula. Short positions may be netted with long positions where the relevant requirements for risk-mitigation

techniques are met; residual short positions should be ignored and not considered to increase in value with the equity shock.

11.45 With regard to benefits, they arise from the clarity and consistency of the treatment. Beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.46 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.47 **Guideline 7** (*Market risk concentration sub-module*) clarifies that undertakings should not apply a risk weight of zero percent for institutions that are owned or unconditionally fully guaranteed by one of the entities mentioned in Article 187 (3) of the Implementing Measures (for which zero percent shall be applied).

11.48 With regard to benefits, they arise from the clarity and consistency of the treatment. The beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.49 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.50 **Guideline 8** (Securities lending transactions and similar agreements) clarifies that the treatment of securities lending or borrowing transactions and repurchase or reverse repurchase agreements including liquidity swaps in the standard formula should follow the recognition of the exchanged items in the Solvency II balance sheet.

11.51 With regard to benefits, they arise from the clarity and consistency of the treatment. The beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.52 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

11.53 **Guideline 9** (*Commitments which may create payment obligations*) clarifies that legally binding commitments, which the undertaking has provided or arranged and may create payment obligations depending on the credit standing or default on a counterparty should be recognised as type 1 exposure in the counterparty default risk module and clarifies the calculation of the loss-given-default for such commitments.

11.54 With regard to benefits, they arise from clarity and consistency of treatment. The beneficial effects are direct for undertakings and NSAs but also consumers can indirectly profit from a sounder and more transparent system.

11.55 With regard to costs:

- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
- On the side of NSAs: None;
- On the side of consumers: None.

VI - Comparison of Options

11.56 Against the benchmark defined above, EIOPA considers that the Guidelines do not add any new requirements and do not introduce any new material cost. All the Guidelines have a purely clarifying character.

11.57 In some cases the Guidelines could be perceived by undertakings as generating additional costs. But in fact they simply clarify already existing requirement introduced by the Directive or by the Implementing Measures. As a consequence, no additional costs relative to the existing levels of legislation are created.

11.58 Despite the absence of any material costs the Guidelines produce with certainty beneficial effects, because they improve the clarity and unambiguity of the legislative and regulatory framework. This promotes convergence, compliance and ease of surveillance.

11.59 The benefits are direct for undertakings and NSAs but consumers can also profit from a more transparent and well-founded system. On the basis of these reasons EIOPA decided to adopt all Guidelines.

12. Adjustments for Loss Absorbing Capacity of TP/Deferred Taxes

I - Procedural Issues and Consultation of Interested Parties

- 12.1. The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements and internal models from different national competent authorities and EIOPA.
- 12.2. Selected stakeholders were pre-consulted in the preparation of the Guidelines.
- 12.3. A public consultation of the Guidelines and its Impact Assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' responses to public consultation were duly analysed and served as a valuable input in order to revise the Guidelines.
- 12.4. When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate.

II - Problem Definition

- 12.5. **Regarding Title I:** Article 103 (c) of Solvency II sets out the structure of the standard formula with a Basic Solvency Capital Requirement amended by a capital charge for operational risk as well as adjustments for the loss-absorbing capacity for technical provisions and deferred taxes.
- 12.6. In the calculation for technical provisions for the purpose of the Solvency II balance sheet, profit sharing arrangements are an implicit element of the valuation. In a risk model measuring the variation in basic own funds and properly accounting for the economic reality of the mechanism in stressed circumstances, those arrangements are therefore in place as well.
- 12.7. In the calculation of the Basic Solvency Capital Requirements, a set out in Article 83(1) (c) of the Implementing Measures] valuation and risk model are however "decoupled" by the requirement that the scenario employed should not change the value of future discretionary benefits. The calculation of the Basic Solvency Capital Requirement is thus a hypothetical exercise, for that no technical guidance is provided in the Directive 2009/138/EC and the Implementing Measures. Title I of these Guidelines aims to fill this gap.
- 12.8. **Regarding Title II and Title III:** Article 207 (2) of the Implementing Measures sets out that the value of the adjustment for the loss-absorbing capacity of deferred taxes shall be determined in accordance with the provisions for the valuation and recognition of deferred taxes for the purpose of the Solvency II balance sheet. The Solvency II valuation principles are however not easily transferable to the risk model for several reasons:
- 12.9. First, the valuation of deferred taxes for the purpose of the Solvency II balance is based on a single item principle that cannot be applied in a straightforward manner to the risk model. The reason is that neither the Directive 2009/138/EC nor the Implementing Measures provide for the setting-up of a post stress balance sheet.

- 12.10. Second, the recognition criteria need to be assessed for their applicability to the deferred tax adjustment and with regards to double counting.
- 12.11. Third, it is unclear how the principles should apply in the case of tax groups. Title II and Title III provide clarification on these issues by giving guidance on how the principles set out in the Directive 2009/138/EC] and the Implementing Measures can be applied to manageable methods of calculation.
- 12.12. **Baseline:** When analysing the impact from proposed policies, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention.
- 12.13. For the analysis of the potential related costs and benefits of the proposed Guidelines, EIOPA has applied the baseline described in the Introduction, therefore taking into account the effect of the application of the Solvency II requirements and the relevant Implementing Measures [Articles 205 to 207 of the Implementing Measures].

III - Objectives Pursued

- 12.14. The proposed Guidelines are intended to establish consistent, efficient and effective supervisory practices within the ESFS. Their aim is also to ensure the common, uniform and consistent application of Union Law with respect to the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.
- 12.15. This objective corresponds to the following operational, specific and general objectives in the objectives tree for the Solvency II:
- Harmonised calculation of technical provisions,
 - Harmonised risk sensitive and prospective solvency standards,
 - Improved risk management of EU insurers,
 - Enhancing of policyholder protection,
 - Improved competitiveness of EU insurers.

IV - Policy Options

- 12.16. With the intention to meet the objectives set out in the previous section, EIOPA has analysed different policy options throughout the policy development process.
- 12.17. Below the most relevant policy options (alternative to the baseline) that have been considered in relation to the respective policy issues are summarised.
- 12.18. Apart from specific policy issues there is the general question whether any guidance should be provided for a particular area (i.e. is any supervisory intervention necessary).

Policy Issue 1: Guidance on the determination of future discretionary benefits in the net calculation (Guidelines 3, 4 and 5)

12.19. Policy Option 1.1: Guidance as set out in the Guidelines.

12.20. Policy Option 1.2: Additional guidance.

Policy issue 2: Guidance on the treatment of arrangements for the transfer of profits or losses (Guideline 9)

Policy Issue 2a: Recognition of losses transferred

12.21. Policy Option 2a.1: No recognition of loss transferred without compensation by transferring undertaking

12.22. Policy option 2a.2: Recognition of loss transferred without compensation by transferring undertaking

Policy Issue 2b: Effectiveness of arrangements or contractual agreements under stressed circumstances

12.23. Policy Option 2b.1: Requirements to ensure effectiveness under stressed circumstances

12.24. Policy Option 2b.2: No requirements to ensure effectiveness under stressed circumstances

Policy Issue 2c: Recognition of losses by the receiving undertakings

12.25. Policy Option 2c.1: No recognition of transferred losses by receiving undertaking.

12.26. Policy option 2c.2: Recognition of transferred losses by receiving undertaking.

Policy Issue 3: Possibility for proxies (for the allocation of the loss and for the recognition of notional deferred tax assets)

12.27. Guideline 8 requires that the loss has to be allocated to balance sheet items if the calculation at the sub-module level is not sufficient.

12.28. According to Guideline 12 profit projections for the purpose of demonstrating the recognition of notional deferred tax assets have to be based on the post-stress situation of the undertaking.

12.29. Policy Option 3.1: No possibility for proxies.

12.30. Policy option 3.2: Possibility for proxies (i.e. allocation of the loss at sub-module level (Guideline 8) and recognition of notional deferred tax assets based on an assessment of profits after the one in 200 stress (Guideline 12)).

Policy Issue 4: Eligibility proof for notional deferred tax assets

12.31.Guideline 13 allows undertakings to disregard notional deferred tax assets if demonstrating their eligibility would be too burdensome.

12.32.Policy option 4.1: Relief of eligibility proof for notional deferred tax assets if deemed too burdensome.

12.33.Policy option 4.2: Eligibility proof for all notional deferred tax assets.

V - Analysis of Impact

12.34.With respect to the baseline it is possible to identify the costs and benefits for EIOPA interventions as set out in this chapter.

12.35.There is the general question whether any guidance should be provided for a particular area. Some of the proposed Guidelines have a purely clarifying and explanatory character. No Guideline would also generally mean less convergence with respect to the supervisory assessment of the applied methods.

12.36.It would be left to NSAs and undertakings to come up with appropriate assumptions and methods based on the requirements set out in Solvency II and the Implementing Measures.

12.37.For the determination of future discretionary benefits this would have meant for example that requirements had to be derived from the valuation principles set out in Articles 23 and 24 of the Implementing Measures].

12.38.EIOPA deems that the provision of guidance per se does not introduce additional costs for undertakings, NSAs and policy holders. At the same time all benefit (directly or indirectly) from the additional degree of clarity and harmonisation.

12.39.Below the costs and benefits for the specific policy issues are summarised.

Policy Issue 1: Guidance on the determination of future discretionary benefits in the net calculation.

Option 1.1

12.40.***Benefits (relative to Option 1.2):***

- For undertakings: Potentially more accurate reflexion of risk profile in calculation of SCR due to higher modelling freedom of future discretionary benefits;
- For NSAs: Potentially more accurate reflexion of risk profile in calculation of SCR due to higher modelling freedom of future discretionary benefits;
- For policyholders: Potentially more accurate reflexion of risk profile in calculation of SCR due to higher modelling freedom of future discretionary benefits;

12.41. *Costs (relative to Option 1.2):*

- For undertakings: Lower degree of comparability between undertakings in terms of future discretionary benefits modelling;
- For NSAs: Lower degree of comparability between undertakings in terms of future discretionary benefits modelling;
- For policyholders: Lower degree of comparability between undertakings in terms of future discretionary benefits modelling;

Option 1.2

12.42. *Benefits (relative to Option 1.1):*

- For undertakings: Higher degree of comparability between undertakings in terms of future discretionary benefits modelling;
- For NSAs: Higher degree of comparability between undertakings in terms of future discretionary benefits modelling;
- For policyholders: Higher degree of comparability between undertakings in terms of future discretionary benefits modelling.

12.43. *Costs (relative to Option 1.1):*

- For undertakings: Potentially less accurate reflexion of risk profile in calculation of SCR; potentially disproportionate limitation in the choice of investment decisions;
- For NSAs: Potentially less accurate reflexion of risk profile in calculation of SCR;
- For policyholders: Potentially less accurate reflexion of risk profile in calculation of SCR;

Policy issues 2: Guidance on the treatment of arrangements for the transfer of profits or losses (Guideline 9)

Policy Issue 2a: Recognition of losses transferred

Option 2a.1

12.44. *Benefits:*

- For undertakings: More accurate reflexion of risk profile in calculation of regulatory capital; convergence with regard to supervisory assessments.
- For NSAs: More accurate reflexion of risk profile in calculation of regulatory capital; convergence with regard to supervisory assessments.
- For policyholders: More accurate reflexion of risk profile in calculation of regulatory capital;

12.45. *Costs:*

- For undertakings: Potential limitation of arrangements for the transfer of losses;
- For NSAs: Potentially higher costs connected with supervisory assessments;
- For policyholders: None.

Option 2a.2

12.46. *Benefits:*

- For undertakings: Possibility to liaise with supervisors on a case by case basis;
- For NSAs: None;

- For policyholders: None.

12.47. **Costs:**

- For undertakings: Less accurate reflexion of risk profile in calculation of SCR; inconsistent application of a group support.
- For NSAs: Less accurate reflexion of risk profile in calculation of SCR; inconsistent application of a group support.
- For policyholders: Less accurate reflexion of risk profile in calculation of SCR;

Policy Issue 2b: Effectiveness of arrangements or contractual agreements under stressed circumstances

Option 2b.1

12.48. **Benefits:**

- For undertakings: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency positions of undertakings; consistency with general requirements for risk mitigation techniques.
- For NSAs: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency positions of undertakings; consistency with general requirements for risk mitigation techniques.
- For policyholders: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency positions of undertakings.

12.49. **Costs:**

- For undertakings: Higher costs for calculation and its justification to NSAs
- For NSAs: Higher costs for review of calculations
- For policyholders: None;

Option 2b.2

12.50. **Benefits:**

- For undertakings: Lower costs for calculation and its justification to NSAs
- For NSAs: Potentially lower costs for review of calculations
- For policyholders: None;

12.51. **Costs:**

- For undertakings: Lower degree of comparability between the solvency positions of undertakings; less accurate reflexion of risk profile in calculation of SCR;
- For NSAs: Lower degree of comparability between the solvency positions of undertakings; less accurate reflexion of risk profile in calculation of SCR;
- Lower degree of comparability between the solvency positions of undertakings; less accurate reflexion of risk profile in calculation of SCR;

Policy Issue 2c: Recognition of losses by the receiving undertakings

Option 2c.1

12.52. Benefits:

- For undertakings: Consistency with the total balance sheet approach;
- For NSAs: Consistency with the total balance sheet approach;
- For policyholders: None.

12.53. Costs:

- For undertakings: Potentially limitation of arrangements for the transfer of losses.
- For NSAs: Potentially limitation of arrangements for the transfer of losses.
- For policyholders: None.

Option 2c.2

12.54. Benefits:

- For undertakings: Potentially no limitation in entering in tax group arrangements.
- For NSAs: None;
- For policyholders: None.

12.55. Costs:

- For undertakings: Inconsistent application of a group support
- For NSAs: Inconsistent application of a group support
- For policyholders: None.

Policy Issue 3: Possibility for proxies (for the allocation of the loss and for the recognition of notional deferred tax assets)

Option 3.1

12.56. Benefits:

- For undertakings: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency position of undertakings;
- For NSAs: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency position of undertakings;
- For policyholders: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between the solvency position of undertakings;

12.57. Costs:

- For undertakings: Higher modelling costs
- For NSAs: Potentially higher costs for review of calculations
- For policyholders: None;

Option 3.2

12.58. Benefits:

- For undertakings: Lower modelling costs
- For NSAs: Potentially lower costs for review of calculations
- For policyholders: None;

12.59. **Costs:**

- For undertakings: Less accurate reflexion of risk profile in calculation of SCR; lower degree of comparability between solvency position of undertakings;
- For NSAs: Less accurate reflexion of risk profile in calculation of SCR; lower degree of comparability between solvency position of undertakings;
- For policyholders: Less accurate reflexion of risk profile in calculation of SCR; lower degree of comparability between solvency position of undertakings;

Policy Issue 4: Eligibility proof for notional deferred tax assets

Option 4.1

12.60. **Benefits:**

- For undertakings: Lower costs for calculation;
- For NSAs: Lower costs for review of calculation;
- For policyholders: Better protection due to better solvency position of undertakings;

12.61. **Costs:**

- For undertakings: Lower degree of comparability between solvency position of undertakings;
- For NSAs: Lower degree of comparability between solvency position of undertakings;
- For policyholders: Lower degree of comparability between solvency position of undertakings;

Option 4.2

12.62. **Benefits:**

- For undertakings: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between solvency position of undertakings;
- For NSAs: More accurate reflexion of risk profile in calculation of SCR; higher degree of comparability between solvency position of undertakings;
- For policyholders: None;

12.63. **Costs:**

- For undertakings: Higher costs for calculation;
- For NSAs: Higher costs for review of calculation;
- For policyholders: None;

VI - Comparing the Options

12.64. Before the specific policy issues are discussed there is the general question whether guidance is needed at all for the areas covered in the Guidelines.

12.65. As the provision of guidance per se does not introduce additional costs for undertakings, NSAs and policy holders and they benefit from the additional degree of clarity and harmonisation EIOPA concluded that guidance on the areas covered in the Guidelines has a net beneficial effect.

Policy Issue 1: Guidance on the determination of future discretionary benefits in the net calculation

6.77. There can be considerable differences between undertakings in terms of their ability to influence future discretionary benefits and these differences have potentially a large impact on the loss-absorbing capacity of technical provisions. It seems therefore important to allow undertakings enough flexibility in reflecting their individual situation. As a consequence, EIOPA chose **Option 1.1**.

Policy Issue 2a: Recognition of losses transferred

12.66. Without compensation the transferring undertaking would have no increase in assets or decrease in liabilities to offset losses. Option 2a.2 seems also to be inconsistent with the total balance sheet approach. Moreover, it would be equivalent with introducing the concept of group support. Therefore EIOPA chose **Option 2a.1**.

Policy Issue 2b: Effectiveness of arrangements or contractual agreements under stressed circumstances

12.67. It might be perceived as burdensome to demonstrate the effectiveness under stressed conditions. But without taking into account the ability of the receiving party to honour its obligations also in a period of stress the calculation of the SCR would not be accurate. Therefore EIOPA chose **Option 2b.1**.

Policy Issue 2c: Recognition of losses by the receiving undertakings

12.68. The recognition of losses by the receiving undertakings would have been in contrast with the total balance sheet approach. Therefore EIOPA chose **Option 2c.1**.

Policy Issue 3: Possibility for proxies (for the allocation of the loss and for the recognition of notional deferred tax assets)

12.69. Allowing for proxies would create wide differences in supervisory practice. As a consequence the comparability of the solvency positions across undertakings would suffer. Therefore EIOPA chose **Option 3.1**.

Policy Issue 4: Eligibility proof for notional deferred tax assets

12.70. Option 4.1 lowers the costs for the calculation and its review. The potentially negative effects of the simplification seem limited as it would result in an overestimation of the regulatory capital requirement. Therefore EIOPA chose **Option 4.1**.

13. Basis Risk

I - Procedural Issues and Consultation of Interested Parties

- 13.1 The EIOPA Guidelines on Basis Risk aim at increasing consistency and convergence of professional practice with respect to the treatment of risk mitigation techniques in the standard formula for all types and sizes of undertakings.
- 13.2 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements from different national competent authorities and EIOPA.
- 13.3 Stakeholders were pre-consulted in the preparation of the Guidelines.
- 13.4 Specific attention has been given to proportionality issues. When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation, please see the "*Cover note for the Consultation Paper on Guidelines on preparing for Solvency II*".

II - Problem Definition

- 13.5 It has been noticed that undertakings are not fully certain how to consider the basis risk arising from use of risk mitigation techniques in the standard formula.
- 13.6 Without EIOPA intervention different readings and interpretations of the Directive and the Implementing Measures could have emerged giving rise to uncertainty and slowing convergence of practices across Member States. A possible result would be additional costs for undertakings to comply and supervisors to verify this.

III - Objective Pursued

- 13.7 The Guidelines aim at facilitating convergence of practices across Member States and supporting undertakings in the treatment of risk mitigation techniques in the standard formula.
- 13.8 In particular, the aim is twofold:
- to support the consistent interpretation of the Directive and the Implementing Measures and thus contributing towards harmonisation across Member States.
 - to increase consistency and convergence of professional practices in the treatment of risk mitigation techniques in the standard formula for all types and sizes of undertakings.

- 13.9 When analysing the impact of these Guidelines, the methodology foresees the use of the baseline scenario as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The baseline scenario allows assessing how the current situation would evolve without additional regulatory intervention.
- 13.10 For the analysis of the potential related costs and benefits of the proposed Guidelines on Basis risk, EIOPA has applied as a baseline the previous levels of legislation. This is in line with the baseline described in the Introduction.

IV - Policy Options

- 13.11 To ensure a harmonised interpretation and coherent application of the previous levels of legislation, EIOPA discussed the adoption of three Guidelines on:
- Risk mitigation techniques with no material basis risk;
 - Financial Risk-mitigation techniques: assessment criteria of basis risk; and
 - Insurance risk-mitigation techniques with no material basis risk.
- 13.12 Each Guideline has a purely explanatory and clarifying character. Its effects in terms of benefits and costs are evaluated relative to a scenario (the baseline) in which EIOPA does not issue any Guideline to complement the previous levels of legislation.
- 13.13 Therefore, for each Guideline the decision is whether to adopt it or not.

V - Analysis of Impact

- 13.14 Relative to the baseline it is possible to identify the following benefits and costs for the introduction of each of the Guidelines.
- 13.15 **Guideline 1** (Risk mitigation techniques with no material basis risk) clarifies what main conditions inter alia have to be met for a risk mitigation technique to have no material basis risk. They complement the requirements for the recognition of risk mitigation techniques in the standard formula calculation set out in the Implementing Measures.
- 13.16 With regard to benefits: The Guideline provides clarity when the basis risk resulting from the use of risk mitigation techniques should be regarded as material. This supports a consistent treatment across undertakings.
- 13.17 With regard to costs:
- On the side of undertakings: None as it is merely a clarification without the creation of any additional requirements;
 - On the side of NSAs: None;
 - On the side of consumers: None.
- 13.18 The Guideline has a pure clarifying and explanatory character without adding any new requirements on top of the previous levels of legislation.

- 13.19 **Guideline 2** (Financial risk-mitigation techniques: assessment criteria of basis risk) clarifies the aspects undertakings need to consider when assessing the materiality of basis risk.
- 13.20 With regard to benefits: A set of criteria for assessing material basis risk provides clarity to undertakings. This is also beneficial for NSAs as it reduces the risk that undertakings erroneously classify risk mitigation techniques as resulting or not resulting in material basis risk and ensures a consistent interpretation of the Solvency II regulation.
- 13.21 With regard to costs:
- On the side of undertakings: Not material because it is merely a clarification without the creation of any additional obligation or requirement;
 - On the side of NSAs: None.
 - On the side of consumers: None.
- 13.22 The Guideline has a purely clarifying and explanatory character without adding any new requirements on top of the previous levels of legislation.
- 13.23 **Guideline 3** (Insurance risk-mitigation techniques with no material basis risk) clarifies the treatment of insurance risk mitigation techniques (in particular where the exposure covered by the risk mitigation technique is denominated in a different currency than the exposure of the undertaking).
- 13.24 With regard to benefits, they are in the form of clarity and consistency of treatment. For NSAs, an additional advantage is that there is a lower risk undertakings take erroneously credit for insurance risk mitigation techniques with material basis risk in the standard formula thus overstating their solvency position.
- 13.25 With regard to costs:
- On the side of undertakings: not material as it is merely a clarification on appropriate treatment of risk mitigation techniques without the creation of any additional obligation or requirement;
 - On the side of NSAs: none;
 - On the side of consumers: none.
- 13.26 The Guideline is of purely clarifying and explanatory nature without adding any new requirements on top of the previous levels of legislation (the Directive and the Implementing Measures).

VI - Comparison of Options

- 13.27 With no additional implementation cost but beneficial effects for (re)insurance undertakings and supervisory authorities, the three Guidelines are certain to produce a net beneficial benefit. Policy holders also benefit from a clear and unambiguous legislative and regulatory framework.

14. Undertaking-Specific Parameters

I - Procedural Issues and Consultation of interested Parties

- 14.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on financial requirements from different national competent authorities and EIOPA.
- 14.2 Stakeholders were pre-consulted in the preparation of the Guidelines. A public consultation of the Guidelines and its Impact Assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' responses to public consultation were duly analysed and served as a valuable input in order to revise the guidelines.
- 14.3 When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".
- 14.4 National Supervisory Authorities (NSAs) should take into account the proportionality principle when reviewing the application for the use of undertaking-specific parameters (USP) by an insurance or reinsurance undertaking. However, they should bear in mind that the proportionality principle should not be understood as waving or lowering any requirements.
- 14.5 In particular, NSAs should take into account the proportionality principle by considering the nature, scale and complexity of the risks an insurance or reinsurance undertaking is exposed to when deciding on the extent of the reviews in the course of the approval process.

II - Problem Definition

- 14.6 Article 111 (1a) of Solvency II provides for supervisory approval based on specified criteria before the use of USP by insurance and reinsurance undertakings. These criteria are set out in detail in the Implementing Measures, ITS and EIOPA Guidelines. Groups need an approval for the use of group-specific parameters (GSP) to calculate their Solvency Capital Requirement.
- 14.7 The requirements on USP can be separated in two distinct parts: The ones covering the approval process and the ones dealing with the governance surrounding data to be used for the methods described in Implementing Measures.
- 14.8 The Guidelines provide clarification on the data and their governance in the context of USP, continuous compliance with the requirements for USP as well as the supervisory approval to use GSP. Without these Guidelines there would be a risk that USP methods were undermined by the use of inappropriate or low quality data.
- 14.9 When analysing the impact of policies a baseline scenario is used as the basis for comparing policy options. This helps to identify the incremental impact of

each policy option considered. The baseline scenario describes how the current situation would evolve without additional regulatory intervention.

14.10 EIOPA has used the existing legislation as a baseline for analysing the potential costs and benefits of the proposed Guidelines on USP. In particular, the baseline relative to which additional effects are measured is in line with the definition provided in the introduction.

14.11 Taking into account this baseline scenario, EIOPA considers that these Guidelines do not add any new requirements. However, some clarifications could be perceived as generating additional costs.

14.12 This additional cost is considered limited compared to the gain in clarity that the Guidelines provide.

III - Objectives Pursued

14.13 A main objective of the Guidelines is to explain the expectations on the quality of data used to calculate USP.

14.14 The Guidelines on USP provide clarification on the following topics:

- Criteria that should be met by data (internal and external) to be used for the calculation of USP;
- The circumstances in which undertakings should provide information on their compliance with the USP requirements to the supervisory authority and the kind of information; and
- The mutatis mutandis application of the provisions for USP to GSP.

IV - Policy Options

14.15 In the case of USP there is only one policy option at stake: To provide guidance for the application of existing legislation or not.

14.16 For this reason, the structure of this IA is slightly simplified, and the content of the chapters "Policy Options" and "Analysis of Impact" is merged.

V - Analysis of Impact

14.17 The EIOPA Guidelines aim at complementing existing legislations with clarifications and specifications. Relative to the baseline the costs and benefits of an EIOPA intervention as set out below can be identified.

14.18 For this purpose the Guidelines treating the same issue or tackling the same kind of problem are grouped together. As only one option is taken into consideration, the sections listing alternative options and analysing impacts are in this particular case merged.

14.19 **Guideline 1** explains the role of expert judgement. Alternatively, it could have been contemplated not to formulate requirements on the use of expert judgement in the context of data for the calculation of USP, in particular regarding the substitution of missing data with expert judgement.

14.20 However, to achieve a framework consistent with the one for internal models the same level of scrutiny as in the tests and standards for internal models would have to be applied. Otherwise the robustness of the Solvency Capital Requirement calculation might be jeopardized.

14.21 Such a framework would have been disproportionately burdensome for small undertakings and open to divergence in supervisory approaches. Additionally, there could have been a significant risk of applications being rejected due to a use of expert judgement that is not in line with the requirements.

14.22 Although the scope for using expert judgement in the context of USP may be perceived as less flexible than for internal model, it is therefore also less burdensome.

14.23 The additional costs and benefits of having Guidelines can be summarised as follows:

14.24 With regard to costs:

- on the side of undertakings: less flexibility in the use of data;
- on the side of NSAs: none;
- on the side of policy holders: none.

14.25 With regard to benefits:

- on the side of undertakings: less burdensome framework;
- on the side of NSAs: proportional, consistent and robust prudential outcomes;
- on the side of policyholders: More adequate level of protection.

14.26 **Guideline 2** clarifies the expectations in term of data quality. The intention is to reduce the risk that applications have to be rejected because undertakings wrongly assume that the quality criteria for data do not fully apply for small lines of business.

14.27 The additional costs and benefits of having a Guideline can be summarised as follows:

14.28 With regard to costs:

- on the side of undertakings: none, as the requirements in the existing legislation apply irrespective of the size of the business line;
- on the side of NSAs: none;
- on the side of policy holders: none.

14.29 With regard to benefits:

- on the side of undertakings: mitigation of the risk that an application has to be rejected due to misunderstandings regarding the requirements for less significant lines of business;
- on the side of NSAs: proportional, consistent and robust prudential outcomes;
- on the side of policy holders: more adequate level of protection.

14.30 **Guidelines 3, 4 and 5:**

- explain how to treat the effect of risks that are not relevant over the next year (Guideline 3),
- increase data quality by requiring policies and procedures dealing with catastrophe event and reinsurance programs (Guideline 4), and

- explain the criteria on the data to calculate the non-proportional reinsurance factor (Guideline 5).

14.31 The intention is to reduce the risk of applications being rejected because of uncertainty regarding the necessary data adjustments to achieve an appropriate data quality.

14.32 It is important to note that EIOPA deemed the requirement of completeness as sufficiently directly applicable to the data in the context of USP so that no further explanation in a Guideline is necessary.

14.33 Additional costs and benefits of having a Guideline can be summarised as follows:

14.34 With regard to costs:

- on the side of undertakings: none as the outlined requirements are necessary to calculate a Solvency Capital Requirement that complies with the requirements set out in Article 101(3) of Solvency II;
- on the side of NSAs: none;
- on the side of policy holders: none.

14.35 With regard to benefits:

- on the side of undertakings: mitigation of the risk that the application is rejected because the data does not meet the relevant requirements ;
- on the side of NSAs: proportional, consistent and robust prudential outcomes;
- on the side of policy holders: more adequate level of protection.

14.36 **Guidelines 6 and 7** explain:

- how an undertaking should monitor its continuous compliance with the requirements for using USP as well as when and how it should inform the supervisory authority if there are material changes (Guideline 6),
- what an undertaking should do if another method produces more accurate results (Guideline 6), and
- supervisory actions if an undertaking does not comply with the requirements for the use of undertaking-specific parameters and in particular how much time the supervisory authority should allow the undertaking to restore compliance with the requirements (Guideline 7).

14.37 Additional costs and benefits of having Guideline 6 can be summarised as follows:

14.38 With regard to costs:

- on the side of undertakings: limited (additional reporting);
- on the side of NSAs: none;
- on the side of policy holders: none.

14.39 With regard to benefits:

- on the side of undertakings: standardised information to be provided to NSAs instead of ad hoc requests;
- on the side of NSAs: up to date information from undertakings;
- on the side of policy holders: more adequate level of protection.

- 14.40 A policy choice with respect to Guideline 7 is the time before the supervisory authority withdraws the approval in the case of non-compliance. Instead of the three months another period could have been chosen. With a considerably shorter period undertakings would have in many cases no realistic chance of restoring compliance. With a considerably longer period undertakings would not be in a position to calculate an accurate Solvency Capital Requirement for an unacceptable period of time.
- 14.41 With the chosen three months undertakings have a realistic chance to restore compliance.
- 14.42 **Guidelines 8 and 9** provide clarification on the assessment of material deviations by NSAs and their requirement to use USP. EIOPA has considered whether:
- Article 110 of Solvency II is clear and precise enough for a direct application by supervisory authorities in the case of requiring (re)insurance undertakings to use USP, or
 - it should be supplemented by Guidelines which harmonize and clarify the application of the requirements in the existing legislation.
- 14.43 In order to avoid misinterpretations and to foster harmonisation EIOPA has chosen the second option.
- 14.44 Additional costs and benefits of having a Guideline can be summarised as follows:
- 14.45 With regard to costs:
- on the side of undertakings: none;
 - on the side of NSAs: none;
 - on the side of policy holders: none.
- 14.46 With regard to benefits:
- on the side of undertakings: none;
 - on the side of NSAs: harmonisation of processes;
 - on the side of policy holders: none.
- 14.47 Guideline 8 requires the supervisory authority to give the undertaking “a reasonable time frame “for submitting an application. Given the wide differences in the individual circumstances a fixed time period would not have been adequate when the use of USP is required by the supervisor authority. At the same time the supervisory authority should have a sufficient degree of flexibility. Therefore a further specification what a reasonable period is would not have been adequate.
- 14.48 **Guidelines 10, 11 and 12** provide clarification on the approval of group specific parameters. EIOPA has considered whether:
- the DA requirements on group specific parameters as well as the ITS on the supervisory approval procedure to use undertaking-specific parameters at the solo level are clear and precise enough for direct application by supervisory authorities and insurance groups for group specific parameters, or
 - the mentioned requirements should be supplemented by Guidelines which clarify how to apply them in case of GSP.

14.49 In order to harmonise the approval for GSP and to avoid misinterpretations, EIOPA has decided to choose the second option.

14.50 Additional costs and benefits of having a Guideline can be summarised as follows:

14.51 With regard to costs:

- on the side of undertakings: none;
- on the side of NSAs: none;
- on the side of policy holders: none.

14.52 With regard to benefits:

- on the side of undertakings: harmonisation of approval processes;
- on the side of NSAs: harmonisation of approval processes;
- on the side of policy holders: none.

14.53 **Guidelines 13 and 14** provide clarification on the involvement of the college of supervisors with respect to GSP. EIOPA has considered whether:

- to harmonise the scope of consultation on the application to use GSP within the relevant college of supervisors and the scope of information for the college of supervisors in the case of an application for solo USP, or
- to leave these decisions to each college of supervisors.

14.54 Taking into account costs and benefits, EIOPA decided to choose the first option.

14.55 Additional costs and benefits of having a Guideline can be summarised as follows:

14.56 With regard to costs:

- on the side of undertakings: none;
- on the side of NSAs: potential cost of providing information to other members of the college of supervisors which goes beyond what would have been agreed in the college;
- on the side of policy holders: none.

14.57 With regard to benefits:

- on the side of undertakings: none;
- on the side of NSAs: minimum level of shared information (especially identified risk connected with the use of USP or GSP);
- on the side of policy holders: none.

VI - Comparison of Options

14.58 The only option taken into consideration is the adoption of the whole set of Guidelines. This final section summarises the pros and cons of this option.

14.59 EIOPA judged that the proposed Guidelines represent all useful completion of previous levels of legislations.

14.60 In fact, they help mitigating the risk that applications are rejected, thus simplifying relationships between undertakings and NSAs and reducing the associated bureaucratic costs.

- 14.61 Moreover, they contribute to the convergence towards appropriate quality standards for data and a harmonised understanding and application of the regulatory framework.
- 14.62 All these beneficial effects are achieved with limited additional costs or even with gains in terms of the regulatory burden that would have been otherwise necessary.
- 14.63 Policy holders will benefit from high quality standards for data and the transparency assured by the set of explanations and clarifications provided by EIOPA.

Chapter VI – Full and Partial Internal Models

15. Full and Partial Internal Models

Introduction

As far as Internal Models are concerned, Eiopa judged that only the following Guidelines add new requirements:

- Validation policy;
- Validation report;
- Documentation user manuals or process descriptions;
- Internal model work plan assessment and approval process of internal models for groups.

Full IA reports are developed and enclosed only for these Guidelines. The other Guidelines involve no additional requirements, taking into account that undertakings applying for and using an internal model to calculate the Solvency Capital Requirement under Solvency II have to comply with Directive 2009/138/EC requirements as further specified in the Implementing Measures. Therefore they either do not create additional costs or create much limited and circumscribed costs.

For the sake of simplicity and readability, for these Guidelines not provoking additional costs IA reports are presented in a more synthetic and concise style.

15.0 General Introduction

15.0.1 The EIOPA Guidelines on the Use of Internal Models aim to provide guidance on what national competent authorities and insurance or reinsurance undertakings should consider in order that national competent authorities are able to approve the use of an internal model for the calculation of the Solvency Capital requirement and for insurance and reinsurance undertakings to be able to use an internal model for the calculation of its Solvency Capital Requirement in compliance with the Directive requirements as further specified in the Implementing Measures.

15.0.2 Most of these Guidelines were part of the EIOPA Preparatory Guidelines on pre-application for internal models.

15.0.3 EIOPA has considered the impact of the proposed Guidelines on the main stakeholders: undertakings, supervisory authorities and policyholders.

15.0.4 The analysis of the impact has considered whether there are requirements introduced by the Guidelines in addition to the existing requirements in the Directive 2009/138/EC and the Implementing Measures. A formal definition of the baseline is offered in the Introduction to this Report.

15.0.5 Taking into account this baseline scenario, EIOPA considers that only the following Guidelines add new requirements:

- Validation policy;
- Validation report;
- Documentation user manuals or process descriptions; and
- Internal model work plan for the assessment and the approval process of internal models for groups.

15.0.6 Specific Impact Assessment reports for these Guidelines are included below.

15.0.7 The other Guidelines involve no additional requirements, taking into account that undertakings applying for and using an internal model to calculate the Solvency Capital Requirement under Solvency II have to comply with Directive 2009/138/EC requirements as further specified in the Implementing Measures. Therefore they either do not create additional costs or create limited costs. Consideration of this can be found after the specific Impact Assessment reports for the Guidelines which add new requirements.

15.1 Validation policy

I - Procedural Issues and Consultation of Interested Parties

15.1.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on internal models from different national competent authorities and EIOPA.

15.1.2 Stakeholders were pre-consulted in the preparation of the Guidelines.

II - Problem Definition

15.1.3 Undertakings using internal models for the calculation of their Solvency Capital Requirements should comply with the validation standards set out in Article 124 of Solvency II as further specified in Articles 241 and 242 of the Implementing Measures].

15.1.4 For this purpose the undertaking should have a model validation process specifying:

- the processes and methods used to validate the internal model and their purposes;
- for each part of the internal model, the frequency of regular validations and the circumstances which trigger additional validation;
- the persons who are responsible for each validation task;
- the procedure to be followed in the event that the model validation process identifies problems with the reliability of the internal model and the decision-making process to address those concerns.

III - Objective Pursued

15.1.5 The objective of the Guideline on “Validation policy” is to determine the best way the undertaking can specify the main aspects that the validation process should have and, in particular, the ones referred to above.

IV - Policy Options

15.1.6 Two Options were foreseen:

- Policy Option 1: Establish, implement and maintain a written validation policy by the undertaking, specifying at least the issues listed in 2.
- Policy Option 2: Not putting in place a written validation policy.

V - Analysis of Impact

15.1.7 With respect to the baseline it is possible to identify the following costs and benefits for each of the options.

Option 1

15.1.8 With regard to costs on the side of undertakings:

- Undertakings will need to devote time and resources for elaborating the formal validation policy, implement and maintain it;
- They may need to update the policy to adapt to new circumstances.

15.1.9 With regard to costs on the side of national competent authorities:

- national competent authorities will have to dedicate specific resources to review the policy established by the undertaking and its appropriateness.

15.1.10 With regard to costs on the side of consumers:

- Not foreseen.

15.1.11 With regard to benefits on the side of undertakings:

- With a written policy, the validation activities will be carefully set out in a formal document where a clear explanation of what should be covered in the validation process and how, is provided;
- This will bring more control and adequate governance around all the validation process;
- They may be less exposed to the key-person risk in relevant persons carrying out the validation leave the undertaking.

15.1.12 With regard to benefits on the side of national competent authorities:

- The review of the policy will facilitate supervisory authorities the assessment of the compliance by the undertaking of the requirements related to the internal model validation, avoiding ad-hoc requests and saving costs associated to such requests;
- In addition, having the specifications of the validation process available in the policy will simplify the relationship between undertakings and supervisory authorities.

- 15.1.13 With regard to benefits on the side of consumers:
- Consumers would benefit from the sounder governance and the higher level of transparency associated with a more formal validation process.

Option 2

- 15.1.14 With regard to costs on the side of undertakings:
- Undertakings may not have in a formal written document how the validation process will be carried out, and therefore it will be more difficult to adopt and communicate internally the aspects that are needed to perform the validation process;
 - They may lose some control over the validation process;
 - They may be more exposed to the key-person risk in relevant persons carrying out the validation leave the undertaking;
 - It may be more difficult for them to comply with the validation requirements.
- 15.1.15 With regard to costs on the side of national competent authorities:
- More resources would be needed to determine the appropriateness of the validation process carried out by the undertaking.
- 15.1.16 With regard to costs on the side of consumers:
- Consumers would suffer from a less sound validation process.
- 15.1.17 With regard to benefits on the side of undertakings:
- Some costs may be saved, as undertakings will not have to produce, implement and maintain the formal policy.
- 15.1.18 With regard to benefits on the side of national competent authorities:
- not foreseen.
- 15.1.19 With regard to benefits on the side of consumers:
- Not foreseen.

VI - Comparing the Options

- 15.1.20 A written validation policy, established, implemented and maintained by the undertaking, as set out in Option 1, is an extremely helpful tool to ensure that the undertaking has in place a sound validation process and good governance around the validation of the internal model.
- 15.1.21 EIOPA believes that, in the absence of this document (Option 2), the validation process could become more difficult to control by the undertaking, making it less efficient. It would also make for difficult the reviews of the validation requirements by supervisory authorities.
- 15.1.22 In addition, if there is no requirement of having a policy, some undertakings will implement a written policy, while some others will not. This would lead to a less consistent implementation of the Solvency II framework in this area.

15.1.23 On the basis of these arguments, EIOPA opted for Option 1.

15.1.24 The insurance or reinsurance undertaking should establish, implement and maintain a written validation policy which specifies at least:

- the processes, and methods and tools used to validate the internal model and their purposes;
- the frequency of regular validation for each part of the internal model and the circumstances that trigger additional validation;
- the persons who are responsible for each validation task; and
- the procedure to be followed in the event that the model validation process identifies problems with the reliability of the internal model and the decision-making process to address those concerns.

15.2 Validation Report

I - Procedural Issues and Consultation of interested Parties

15.2.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on internal models from different national competent authorities and EIOPA.

15.2.2 Stakeholders were pre-consulted in the preparation of the Guidelines.

II - Problem Definition

15.2.3 Undertakings using internal models for the calculation of their Solvency Capital Requirements should comply on an on-going basis with the validation standards set out in Article 124 of Directive 2009/138/EC as further specified in Articles 241 and 242 of the Implementing Measures.

15.2.4 To this end it is expected that the undertaking deals with the results of each validation cycle it carries out and with the conclusions and consequences of this validation.

III - Objective Pursued

15.2.5 The objective of the Guideline on "Validation report" is to determine the best way the results, conclusions and consequences of each validation cycle could be set out by the undertaking, in order that the undertaking can take appropriate actions following the validation of its internal model.

IV - Policy Options

15.2.6 Two Options were foreseen:

- Policy Option 1: Putting in place a validation report by the undertaking, documenting the results for each validation cycle as well as the resulting conclusions and consequences from the analysis of the validation;
- Policy Option 2: Not putting in place a validation report, that would imply having ad-hoc requests by national competent authorities on the conclusions of each validation cycle of the undertaking.

V - Analysis of Impact

15.2.7 With respect to the baseline it is possible to identify the following costs and benefits for each of the options:

Option 1

15.2.8 With regard to costs on the side of undertakings:

- Undertakings will need to devote time and resources for elaborating the formal validation report for each validation cycle;

- The materiality of these costs will vary depending on the level of detail of the validation process performed, the tools used and the actions to be taken as a result.

15.2.9 With regard to costs on the side of national competent authorities:

- National competent authorities will have to dedicate specific resources to review the way the undertaking puts in place the report in order to assess the undertaking's compliance with the validation requirements on an on-going basis;
- The report produced by undertakings for each validation cycle could not fit to potential specific supervisory analyses. If it is the case, national competent authorities could find themselves in the need of asking additional information that cannot be immediately ready.

15.2.10 With regard to costs on the side of consumers:

- Not foreseen.

15.2.11 With regard to benefits on the side of undertakings:

- With formal reports, the validation activity will be carefully recorded in order to be able to ensure the efficiency of the validation and to comply with validation requirements;
- Each cycle of validation of the internal model will have its own formal report, so providing all information necessary to reconstruct and follow during time the evolution of the model and of the governance steps linked to it;
- Moreover, with a formal report there will be incentives towards more control around all the validation process, identifying the data sets used and the different parts involved and their roles;
- If the results of the validation process are documented, it will be easier to report and escalate them within the undertaking in order to take the appropriate decisions and actions that may be needed in the internal model. From this point of view, a formal report works as a real tool to improve the governance around the validation process;
- If the reports cover all possible information and elements that national competent authorities may be interested in, it will help in saving costs associated with ad-hoc requests.

15.2.12 With regard to benefits on the side of national competent authorities:

- National competent authorities will benefit from being able to verify the on-going compliance with validation standards directly in the report, avoiding ad-hoc requests and saving costs associated to such requests;
- In particular, information available would simplify the relationship between undertakings and national competent authorities, limiting the number of ad-hoc request, and most of all those to ask confirmation, on a legal basis, and endorsement of single data or single features.

15.2.13 With regard to benefits on the side of consumers:

- Consumers would benefit from the sounder governance and the higher level of transparency associated with formal validation reports.

Option 2

15.2.14 With regard to costs on the side of undertakings:

- Undertakings may not regularly document the results of each validation cycle, and therefore it will be more difficult to communicate internally and

adopt the appropriate actions that may be needed in the internal model as a result of each validation cycle;

- They may lose some control over the validation process, in particular regarding the tools, data set used and the participants involved;
- It may be more difficult for them to comply with the validation requirements on an on-going basis.

15.2.15 With regard to costs on the side of national competent authorities:

- In the case that in the future the model is approved, there will be a need to assess at every validation cycle whether a report of the validation should be requested to the undertaking;
- More resources needed to determine what the content of the ad-hoc request would be.

15.2.16 With regard to costs on the side of consumers:

- Consumers would suffer from a less sound validation process.

15.2.17 With regard to benefits on the side of undertakings:

- Some costs may be saved, as they would not have to produce the report in each validation cycle.

15.2.18 With regard to benefits on the side of national competent authorities:

- Ad-hoc requests would fit the purpose of specific supervisory needs.

15.2.19 With regard to benefits on the side of consumers:

- Not foreseen.

VI - Comparing the Options

15.2.20 In relation to Option 1 it has to be considered that a validation report is already requested to be included in the application package for the internal model according to the [draft] Implementing Technical Standard on Internal Models Approval Processes. This probably will help undertakings in producing the future reports for each validation cycle if their model is approved.

15.2.21 EIOPA considered, as an alternative option (Option 2), the possibility of not giving a formal nature to the report. The costs of having a formalized report compared to this alternative option are minor. Even if not formalized, the report would need anyway to be correct, complete and readable in all its information; so, all the costs of gathering data, analysing it and deriving management suggestions would be similar if the report was not formalised.

15.2.22 On the basis of these arguments, EIOPA opted for Option 1: National competent authorities will form a view on how the undertaking puts in place a formal validation report in order to stress the importance of the undertaking's validation procedure.

15.3 Documentation User Manuals or Process Descriptions

I - Procedural Issues and Consultation of interested Parties

- 15.3.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on internal models from different national competent authorities and EIOPA.
- 15.3.2 Stakeholders were pre-consulted in the preparation of the Guidelines.

II - Problem Definition

- 15.3.3 Undertakings using internal models for the calculation of their Solvency Capital Requirements should comply with the documentation standards set out in Article 125 of Directive 2009/138/EC as further specified in Articles 243 to 246 of the Implementing Measures.
- 15.3.4 Since the result from the internal model will form the Solvency Capital Requirement and will also form the basis for steering and making decisions (use test) in the undertaking on an on-going basis, it is necessary that the documentation enables an independent knowledgeable third party to determine the state, appropriateness and reliability of the internal model at all times.

III - Objective Pursued

- 15.3.5 The objective of the Guideline on "Documentation user manuals or process descriptions" is to determine the best way the undertaking could ensure that the operation of the model remains appropriate at all times, and how documentation could help on this.

IV - Policy Options

- 15.3.6 Two Options were foreseen:
- Policy Option 1: Request undertakings to have in place detailed user manuals or process descriptions as part of the documentation of the model which should be sufficiently detailed to allow an independent knowledgeable third party to operate and run the model.
 - Policy Option 2: Not doing anything in addition to the baseline.

V - Analysis of Impact

With respect to the baseline it is possible to identify the following costs and benefits for each of the options.

Option 1

- 15.3.7 With regard to costs on the side of undertakings:
- Undertakings will need to devote time and resources to put in place user manuals or process descriptions as part of the documentation of the internal model;

- The materiality of these costs will vary depending on the level of detail of the specific internal model.
- 15.3.8 With regard to costs on the side of national competent authorities:
- Not foreseen.
- 15.3.9 With regard to costs on the side of consumers:
- Not foreseen.
- 15.3.10 With regard to benefits on the side of undertakings:
- The different users of the model within the undertaking will be able to better understand how the model operates;
 - User manuals or process descriptions for operation of the internal model are an important mitigant to key-person risk, which exists both at model design level and model operation level.
- 15.3.11 With regard to benefits on the side of national competent authorities:
- In a similar direction as undertakings, national competent authorities will be able to more easily assess the appropriateness of the way the undertaking run the model.
- 15.3.12 With regard to benefits on the side of consumer:
- Consumers would benefit from the better way the undertaking operates the model.

Option 2

- 15.3.13 With regard to costs on the side of undertakings:
- The key-person risk will be increased;
 - It will be more difficult to go deep into the operation of the model by different users.
- 15.3.14 With regard to costs on the side of national competent authorities:
- It will be more difficult to assess the appropriateness of the way the undertaking runs the model.
- 15.3.15 With regard to costs on the side of consumers:
- Consumers may be less protected as undertakings will be more exposed to the key person risk.
- 15.3.16 With regard to benefits on the side of undertakings:
- Undertakings will not devote resources to put in place user manuals or processes descriptions.
- 15.3.17 With regard to benefits on the side of national competent authorities:
- National competent authorities would not devote resources to assess how the undertaking puts in place user manuals or processes descriptions.
- 15.3.18 With regard to benefits on the side of consumers:
- Not foreseen.

VI - Comparing the Options

- 15.3.19 The benefits of Option1 are higher than the ones of Option 2.

- 15.3.20 These benefits of Option 1 clearly overcome the costs related to its implementation.
- 15.3.21 Since the result from the internal model will form the Solvency Capital Requirement and will also form the basis for steering and making decisions (use test) in the undertaking on an on-going basis, it is necessary that documentation enables an independent knowledgeable third party to determine the state, appropriateness and reliability of the internal model at all times.
- 15.3.22 If the documentation does not include a tool specifying the design and operational details which is not thorough enough, sufficiently detailed and sufficiently complete to be understandable by an independent knowledgeable third party, the undertaking could be faced with increased key-person risk.
- 15.3.23 Therefore it was decided to follow the Option 1: the undertaking should have in place, as part of the documentation of the internal model, user manuals or processes descriptions for operation of the internal model.

15.4 Internal model work plan for assessment and approval process of IM for groups

I - Procedural Issues and Consultation of interested Parties

15.4.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on internal models and groups from different national competent authorities and EIOPA.

II - Problem Definition

15.4.2 In the case of internal model for groups composed of several insurance or reinsurance undertakings which are supervised by national competent authorities of different Member states, those national competent authorities will work together in order to assess the appropriateness of internal model.

III - Objective Pursued

15.4.3 The objective of the Guideline on "Internal model work plan for the assessment and the approval process of internal models for groups" is to ensure that national competent authorities involved in the assessment of an internal model for a group work in an effective and coordinated way.

IV - Policy Options

15.4.4 Two Options were foreseen:

- Policy Option 1: Setting out a detailed work plan for the assessment by the supervisory authorities involved, covering the timeline, the steps, the deliverables and the priorities of the process. This plan should be updated whenever necessary.
- Policy Option 2: Not doing anything in addition to the baseline.

V - Analysis of Impact

With respect to the baseline it is possible to identify the following costs and benefits for each of the options.

Option 1

15.4.5 With regard to costs on the side of undertakings:

- No particular costs, as the costs are generated for the assessment of the internal model for the group by national competent authorities per se and for the need to react on the requests the national competent authorities will make to the different undertakings within the group in order to assess the model.

- 15.4.6 With regard to costs on the side of national competent authorities:
- All supervisory authorities involved (and other national competent authorities in the college), in particular the group supervisor, will have to dedicate specific resources to prepare, discuss and agree on the detailed plan and on its update when necessary;
 - National competent authorities would have to stick to the work plan, so less flexibility can be expected.
- 15.4.7 With regard to costs on the side of consumers:
- No direct costs and benefits are expected for consumers.
- 15.4.8 With regard to benefits on the side of undertakings:
- The requests from national competent authorities involved will follow a logical sequence and the risk of receiving duplication of requests will be reduced.
- 15.4.9 With regard to benefits on the side of national competent authorities:
- National competent authorities will benefit from a clearer and a more efficient process;
 - The supervisory authorities involved would know the tasks they are expected to perform;
 - The governance around the process will be improved;
 - The risk of duplication of tasks will be reduced;
 - An efficient process will make easier the approval process of the application the group may submit
- 15.4.10 With regard to benefits on the side of consumers:
- Consumers would indirectly benefit from the more efficient process.

Option 2

- 15.4.11 With regard to costs on the side of undertakings:
- In the lack of a detailed and coordinated planning, the risks of duplication of requests from different national competent authorities within the college would increase significantly.
- 15.4.12 With regard to costs on the side of national competent authorities:
- The process could become difficult to manage, making it less efficient and more demanding in terms of resources and timing;
 - The risk of duplications of tasks will be increased.
- 15.4.13 With regard to costs on the side of consumers:
- Consumers could be penalised due to a less efficient process.
- 15.4.14 With regard to benefits on the side of undertakings:
- Not foreseen.
- 15.4.15 With regard to benefits on the side of national competent authorities:
- The process could be somehow more flexible.
- 15.4.16 With regard to benefits on the side Consumers:
- Not foreseen.

VI - Comparing the Options

- 15.4.17 A formal work plan, as set out in Option 1, is an extremely helpful tool to ensure the effectiveness of the assessment of internal models for groups by national competent authorities within the college and to stress the importance of a full cooperation between these national competent authorities college during the process.
- 15.4.18 EIOPA believes that, in the absence of this document (Option 2), the process could become difficult to manage, making it less efficient and demanding in terms of resources and timing, and increasing the risk of duplications of tasks.
- 15.4.19 The advantages of having clear and detailed work plan clearly overcome the costs of establishing such plan.
- 15.4.20 Bearing in mind the high importance of ensuring a good cooperation within the college in the assessment of an internal model for a group and in particular for group internal models that the supervisory authorities concerned will have to reach a joint decision, it was decided to follow the Option 1: The group supervisor, in consultation with the other national competent authorities involved, should set up an internal model work plan and the communication rules to follow among these authorities during the assessment and the approval process of internal models for groups.
- 15.4.21 The following Guidelines involve no additional requirements, and therefore they either do not create additional costs or create limited costs. In fact they simply work as clarifications and explications of the elements that undertakings should take into account in order to be able to use an internal model for the calculation of the Solvency Capital Requirement.

15.5 Application for the Approval of Internal Models

15.5.1 The aim of this group of Guidelines is twofold:

- the possibility of setting by supervisory authorities a pre-application process before a formal application is submitted by the undertaking for the use of internal models after the first day on which Solvency II is applicable; and
- provide guidance about some specific elements that have to be considered by group undertakings when submitting an application model to the relevant national competent authorities for the use of an internal models for a group, taking into account the requirements set out in Article 112, 230 and 231 of Directive 2009/138/EC, the Articles 343 to 350 of the Implementing Measures and the Draft Implementing Technical Standard on Internal Models Approval Processes.

15.5.2 For the first Guideline on pre-application, no other option was foreseen, as it was seen as beneficial both for supervisory authorities and undertakings, to have a pre-application phase. For undertakings the Guidelines help them to develop its internal model framework and thereby prepare to submit an application to use an internal model. For supervisors the pre-application is useful to be able to form a view on how prepared the undertaking is to submit an application and therefore to be better prepared to assess the final application if submitted by the undertaking.

15.5.3 In the third Guideline, in the case of an application to use a group internal mode, it was considered as alternative option the possibility of allowing any local supervisory authority concerned to ask directly to the group supervisor to request further information from the group undertaking in relation to a local undertaking. This option has been ruled out in favour of a different solution, in which local supervisory authorities concerned could request further information from the related undertaking it supervises in order to assess how the group internal model is adapted to the local specificities of the Member State of this national competent authority. In any case this national competent authority should inform promptly the group supervisor about such requests for information. This choice was made based on the necessity to avoid overlapping of roles and competences between the supervisory authorities concerned, ensuring at the same time that the group supervisor is able to control the process and the overall requests.

15.5.4 No additional options were foreseen for the rest of the Guidelines in this Chapter.

15.6 Model Changes

- 15.6.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in relation to the relevance and the adequacy of the policy for changing the internal model the undertaking establishes (Article 115 of Directive 2009/138/EC).
- 15.6.2 The second Guideline requests the undertaking to develop a reliable system to identify major changes, taking into account quantitative and qualitative criteria. An alternative option would have been to specify and list what should be considered as major changes for all cases. This last option was not followed as it was considered not proportional: it gives no responsibility to the undertaking to choose its own set of indicators that would fit its risk profile and specific needs.
- 15.6.3 The fourth Guideline of the Chapter provides explanations for model changes and policy for model changes in the context of group internal models used for the calculation of both the group Solvency Capital Requirement and the Solvency Capital Requirement of some related undertakings. An alternative option to the one embedded in the Guideline would have been to let every related undertaking in the group to develop its own policy. This alternative option was not selected because it was considered against the principle of economic unity of a group.
- 15.6.4 For the rest of Guidelines no alternative option was foreseen.

15.7 Use Test

- 15.7.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the use test requirements set out in Article 120 of Directive 2009/138/EC and Articles 223 to 227 of the Implementing Measures.
- 15.7.2 Regarding the Guideline requesting the need to improve the quality of the internal model, an alternative option would have been the use of the internal model by the undertaking in the risk management system and decision-making without analysing any potential changes of the internal model that could improve it. This option was rejected as it does not incentivise the continuous improving of modelling practices, which is considered by EIOPA as a core principle of an internal model framework.
- 15.7.3 For the rest of Guidelines, no additional options were foreseen.

15.8 Assumption Setting and Expert Judgement

15.8.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the requirements related to assumptions setting and expert judgement set out in Directive 2009/138/EC and corresponding Articles of the Implementing Measures.

15.8.2 The Guidelines allow for a better control and knowledge by the undertaking around the assumptions made in the internal model and the use of expert judgment. No alternative options were taken into account.

15.9 Probability Distribution Forecast

15.9.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the requirements related to the probability distribution forecast and knowledge of its risk profile set out in Directive 2009/138/EC and corresponding Articles of the Implementing Measures.

15.9.2 The first Guideline of this Chapter allows for a better expectation management for undertakings in order that the probability distribution forecast can reflect all relevant characteristics of its risk profile. An alternative option would have been to ask for more specific information not up-front, but in the course of on-site inspections. This was considered more onerous and time-consuming and not less costly for the undertaking.

15.9.3 The second Guideline further elaborates on the topic dealt with in the first one.

15.9.4 The rest of Guidelines clarify how the requirements can be met by the undertaking in the case of some features that can affect the richness of the probability distribution forecast. No alternative options were considered.

15.10 Methodology Consistency

15.10.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the requirements related to the consistency between the methods used for the calculation of the probability distribution forecast and the methods used for the valuation of assets and liabilities for solvency purposes.

15.10.2 Regarding the Guideline on consistency check points and the one on aspects of consistency, no alternative options were considered.

15.10.3 Regarding the Guideline on consistency assessment, requesting the undertaking to carry out its analysis about consistency according to the specificities of this undertaking was preferred to the option of setting out of a standardised way to assess it. The first option was considered as more flexible and it has the advantage that it adapts the consistency checks to the specificities of the undertaking.

15.10.4 For the rest of Guidelines no alternative options were considered.

15.11 Calibration - Approximations

15.11.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the requirements related to approximations that would be used to derive the Solvency Capital Requirement from internal models adopting another risk measure than the reference one in the context of Article 122 of Directive 2009/138/EC.

15.11.2 No alternative options than the ones embedded in the Guidelines were considered.

15.12 Profit and Loss Attribution

15.12.1 The aim of the Guideline is to provide guidance about what the undertaking needs to consider in order to comply with the profit and loss attribution requirements set out in Article 123 of Directive 2009/138/EC and Article 240 of the Implementing Measures.

15.12.2 An alternative option has been considered for the Guideline: it could have been possible to link profit and loss with the regulatory capital, instead of the option embedded in the Guideline. It was decided to reject this option, as it was considered that undertakings should follow for these purposes what it makes sense for them from an economic point of view and internal purposes.

15.13 Validation

15.13.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the validation requirements set out in Article 124 of Directive 2009/138/EC and Articles 241 and 242] of the Implementing Measures.

15.13.2 Only the Guidelines on validation policy and on validation report add specific new requirements: "The insurance or reinsurance undertaking should establish, implement and maintain a written validation policy which specifies at least (...). The insurance or reinsurance undertaking should document in a validation report the results of the validation as well as the resulting conclusions and consequences from the analysis of the validation". A detailed Impact Assessment for this Guideline is carried out in previous pages.

15.13.3 For the other Guidelines, no alternative options were taken into consideration. In some cases, though they do not add requirements, these Guidelines may appear generating some limited costs, due to the fact that they make clear and explicit some elements in order to help undertakings to comply with the validation requirements. Nevertheless the benefits for undertakings and national competent authorities clearly overcome these costs.

15.14 Documentation

- 15.14.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the documentation requirements set out in Article 125 of Directive 2009/138/EC and Articles 243 to 246 of the Implementing Measures.
- 15.14.2 Only the Guideline on user manuals or process descriptions adds new specific requirements. A detailed Impact Assessment for this Guideline is carried out in previous pages.
- 15.14.3 The other Guidelines may be source of some slight additional costs, but the benefits for undertakings and national competent authorities clearly overcome these costs.
- 15.14.4 It has to be noted that the Guidelines on Documentation aim to help undertakings to meet the documentation requirements. EIOPA considers the documentation of the model as crucial for undertakings. If documentation is not kept up to date, the undertaking is not protected from key-person risk, which is one of the main reasons that documentation is held.
- 15.14.5 The proportionality principle is particularly relevant for Documentation: for simpler internal models this might result in smaller amounts of documentation. However this should be a consequence of the level of complexity of the model, and not of the thoroughness of its documentation
- 15.14.6 The first Guideline (Control Procedures) provides logical elements that undertakings need to consider in order to ensure the on-going quality of the documentation of their model.
- 15.14.7 The Guideline stating the need that the undertaking evidences, through the documentation of the internal model, detailed understanding about some aspects of the model, further specifies some of the elements that have to be taken into account in relation to the documentation of the model. These elements can be seen as deriving from the need that the undertaking demonstrates a detailed understanding of the internal model and in particular a detailed understanding of the theory and assumptions underlying it.
- 15.14.8 In respect of the Guideline stating that the undertaking should include in the documentation an overall summary of the shortcomings of the internal model, a slight cost may arise from the fact that undertakings will have to consolidate in a single document all the relevant information. Nevertheless this consolidation is useful for both undertakings to contribute to the efficiency of the documentation and for national competent authorities to be able to assess the undertaking's compliance with the internal models requirements.
- 15.14.9 The Guideline stating that the undertaking should consider establishing more than one level of documentation commensurate with the different uses and target audiences, aims at tailoring the documentation of the model to key bodies and key personnel of the undertaking. This is very important since it will facilitate more effective implementation and control of the internal model by the undertaking as well as more effective supervisory

review. This Guideline can add some costs but, at the same time, it should be noticed that putting in place different levels of documentation is not statutory and is left to the consideration of the undertaking.

15.14.10 In respect of the Guideline stating that the undertaking should retain the outputs of the internal model that are relevant for satisfying requirements of Article 120 of Directive 2009/138/EC, some costs may arise for the undertaking. Nevertheless it should be noticed that this EIOPA Guideline simply makes more explicit an element that needs to be taken into account in relation to the use test and the documentation of it.

15.14.11 EIOPA considered also different options for some Guidelines.

15.14.12 For the first Guideline of the Chapter, the alternative option was not expecting undertakings to put any control procedure for the documentation. Here, giving further guidance to ensure convergent practices was preferred, given the importance of the issue.

15.14.13 For the Guideline on the summary of shortcomings, the alternative option was not expecting undertakings to put in place an overall summary of all shortcomings of the internal models in a single document. This option was rejected because it was considered important that the undertaking puts in place a single document presenting shortcomings of the internal model. The cost of the option embedded in the final Guideline was considered to be overcome by the benefits it brings.

15.14.14 For the Guideline on tailored documentation, an alternative option would have been to expect from the undertaking a single level of documentation. Here, it was deemed more useful for the undertaking and national competent authorities to allow the undertaking to consider different levels of documentation according to users and of audience.

15.14.15 For the Guideline related to the outputs of the model, there were two alternative options: either not treating the issue at all, or expecting the undertaking to retain the complete set of all runs of the model (not only the outputs). An intermediate solution was chosen for the Guideline, this was considered more useful and straightforward for the undertaking.

15.14.16 Finally, regarding the last Guideline of the Chapter, the alternative options were again two: either to exclude platforms from the documentation, or to expect undertakings to fully include them. An intermediate solution was found again to ensure both an effective and a proportionate approach: request the undertaking to provide sufficient information about the IT systems used in its model.

15.15 External Models and Data

15.15.1 The aim of this group of Guidelines is to provide guidance about what the undertaking needs to consider in order to comply with the external models and data requirements set out in Article 126 of Directive 2009/138/EC and Article 247 of the Implementing Measures. The use of external models or data does not exempt undertakings to comply with internal models requirements.

- 15.15.2 Only some limited additional costs may arise as a consequence of the fact that EIOPA Guidelines extend for external models and external data the general requirements and other Guidelines set out for other areas for internal models and internal data, such as statistical technical standards, use test, validation standards or documentation standards. These limited costs cannot be attributed to EIOPA Guidelines in a strict sense. EIOPA simply made them explicit, taking into account that external models and data are subject to the same requirements as models and data internally developed by the undertaking as set out in Article 126 of Directive 2009/138/EC.
- 15.15.3 No alternative options have been taken into consideration in the Guidelines.

15.16 Internal Models - Functioning of Colleges

- 15.16.1 The aim of this group of Guidelines is to explain how Colleges of supervisors should function during the assessment of internal models for groups used to calculate the consolidated group Solvency Capital Requirement or both the consolidated group Solvency Capital Requirement and the Solvency Capital Requirement of some related undertakings, taking into account the requirements set out in Directive 2009/138/EC and Articles 343 to 350 of the Implementing Measures.
- 15.16.2 Only the Guideline related to the internal model work plan adds a new concrete requirement: a written work plan that the group supervisor, in consultation with the other national competent authorities involved, should establish, covering the timeline, the steps, the deliverables and the priorities of the assessment and approval process for internal models for groups. A detailed Impact Assessment for this Guideline is carried out in previous pages.
- 15.16.3 The rest of Guidelines may create some costs for national competent authorities within the respective college but these are normal in order to carry out a supervisory assessment in the context of internal models for groups. For these Guidelines no alternative options have been taken into consideration.

Chapter IX – System of Governance

16. System of Governance

I - Procedural Issues and Consultation of Interested Parties

- 16.1 The Impact Assessment was prepared in the course of the policy drafting process, with the contribution of experts on systems of governance from different national competent authorities and EIOPA.
- 16.2 Stakeholders were pre-consulted in the preparation of the Guidelines. Furthermore, a public consultation of the Guidelines and its impact assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' comments were duly taken into account and served as a valuable input in order to revise the Guidelines.

II - Problem Definition

- 16.3 Existing supervisory requirements with regard to the system of governance vary widely across Member States. These differing requirements do not provide a level playing field and for undertakings that are part of cross-border groups or has cross-border branches. Therefore, new requirements should harmonise and streamline supervisory requirements with regard to the system of governance in order to enhance transparency across borders.
- 16.4 Based on the economic crises it became evident that there was a need to strengthen and improve the requirements for the system of governance to ensure a more consistent and harmonised approach and to raise governance standards. Focus will be on how undertakings should manage their processes and procedures, including systems and controls to ensure continuous compliance with legislation and capital requirements.

Proportionality

- 16.5 National Competent Authorities are expected to ensure that the provisions of these Guidelines are applied 'in a manner which is proportionate to the nature, scale and complexity inherent in the business of the insurance and reinsurance undertaking'. The approach aims to ensure that this expectation can be met, and this is reflected in the drafting of the Guidelines in two principal ways:
- In most cases, the Guidelines are principle based,
 - Or drafted with a view to the outcome or supervisory objective that should be met.
- 16.6 When developing the proposed policies EIOPA has considered the respective proportionality aspects and has provided reference as appropriate. For the overall approach to proportionality on the Guidelines under consultation, please see the "Cover note for the Consultation Paper on Guidelines on preparing for Solvency II".

Baseline Scenario

- 16.7 When analysing the impact from policies, the methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of

the baseline scenario is to explain how the current situation would evolve without additional public intervention.

16.8 A detailed definition of the baseline is provided in the Introduction.

III - Objective Pursued

16.9 When assessing the merits of the various policy options and approaches the aim is to deliver a system that addresses the weaknesses of the current regime, in particular with respect to removing obstacles to the proper functioning of the single market, whilst achieving an appropriate balance between the objectives of enhancing the protection of policyholders and beneficiaries and improving the international competitiveness of EU insurers and reinsurers.

IV - Policy Options

16.10 It was agreed to describe policy options not Guideline by Guideline, or group by group of Guidelines, but by themes. In fact, the Guidelines are all strictly linked and interrelated, and analysing them one by one would have ended up in a too fragmented and partial description. After discussion, it has been judged more appropriate to present directly policy options EIOPA considered, and then offer motivations about the preferred final choice. This way of constructing the reasoning appeared more adherent to the goals at the basis of system of governance.

16.11 EIOPA has identified different options on four main policy issues that were considered in the development of the Guidelines. The identified options are based on what EIOPA believes could have the most significant impact on undertakings and the level of protection of policyholders as well as beneficiaries. The focal point of the options identified is how an underlying problem could evolve, all things being equal, if such options were not decided upon.

16.12 It is also worth highlighting that against the baseline the proposed Guidelines should not create material new requirements for undertakings. Instead, they give guidance as well as steering on what would be expected from the undertakings by national supervisors. Hence, for undertakings to comply with the Guidelines no additional incremental costs are envisaged.

Issue 1: Whether to specify the difference between, and terminology of, risk tolerance and risk appetite

16.13 EIOPA discussed whether to neither define nor clarify the terminology of risk tolerance and risk appetite at all since the terms are widely used and are understood differently within the financial sector or, perhaps, just to define characteristics of the terms used but not give definitions to ensure some basis for a common understanding. Finally it was discussed whether to prescribe a Solvency II definition of the terms to ensure a harmonised understanding between members and to ensure a common approach when reading the Guidelines.

Issue 2: Whether to develop Guidelines on Prudent Person Principle as part of the System of Governance

16.14 Based on Article 132 of Solvency II, EIOPA discussed whether to include Guidelines on the Prudent Person Principle (PPP) as part of the System of Governance on account of the reference to PPP in Article 44 of Solvency II, or to leave it out.

Issue 3: Whether to include minimum requirements on the use of derivatives in the Guidelines

16.15 Article 44 of Solvency II requires that the risk management system of an undertaking cover among other things investments, in particular derivatives and similar commitments. The prudent person principle in Article 132 of Solvency II requires that undertakings only invest in assets whose risks can be properly identified, measured, monitored, managed and reported. Paragraph 4 of that Article also sets out some specific requirements on the use of derivatives. EIOPA discussed whether the requirements within Solvency II addressing the use of investments, including the above articles, should be complemented by further guidelines that specifically addressed requirements relevant to the use of derivatives by undertakings.

Issue 4: Whether to require combined annual information from the Actuarial Function to the AMSB or leave it up to the undertaking to decide how and when the information is to be provided

16.16 According to Article 48(1) of Solvency II the Actuarial Function has to inform the AMSB about several subjects regarding the coordination or calculation of technical provisions. However, this does not include requirements on how this should be conducted. Hence, it was discussed whether the Actuarial Function has to provide to the AMSB combined information on an annual basis on all relevant issues or if the information should be provided whenever deemed necessary.

16.17 However, as the implementing measures clearly ask for an annual submission of the actuarial function report to the AMSB, this Guideline could be deleted from the scope of the past preparatory Guidelines. EIOPA has discussed if further guidance should be provided whether this report can be only submitted as one report or whether several reports can be submitted to the AMSB if the condition is met that all tasks of the actuarial function are covered with these reports. EIOPA concluded that a flexible approach does not harm the objectives of Solvency II and has left the implementation to national supervisory practice. EIOPA is of the opinion that this flexible approach does not require any further analysis of the costs and benefits for industry, for NCAs and for policyholders, because the issue is only being dealt with internal in each (re-)insurance undertaking.

V - Analysis of Impact

- 16.18 As a consequence of the choice of describing options not Guideline by Guideline, nor group by group of Guidelines, but by theme, it was agreed to give to this chapter a structure symmetric to the structure of the previous chapter. For each option, arguments are constructed to prepare the selection of the preferred one. In the next chapter, these pros and cons are compared in order to arrive to the final choice. For each preferred option, the next chapter will summarise pros and cons for all actors involved, with the breakdown for undertakings, supervisors and policy holders.
- 16.19 In the Solvency II project, policy-makers have already considered, analysed and compared a number of policy options. Based on the impact assessment already done for the requirements set in Solvency II EIOPA has considered a wide range of policy options referring to the Guidelines. In this section EIOPA would like to show alternative options which were considered and preferred options that have been analysed seriously, and to explain why they were not pursued.
- 16.20 During the analysis, the principle of proportionality was always taken into account, as the Community actions should not go beyond what is necessary to achieve satisfactorily the objectives which have been set. Due to their size and scarce resources, small and medium sized undertakings (SMEs) can be affected by the costs of regulations more than their bigger competitors. At the same time, the benefits of regulations tend to be more evenly distributed over entities of different sizes. SMEs may have limited scope for benefiting from economies of scale. SMEs in general find it more difficult to access capital and as a result the cost of capital for them is often higher than for larger businesses. Therefore, the principle of proportionality was always taken into account while considering different options.

Issue 1: Whether to specify the difference between and terminology of risk tolerance and risk appetite

- 16.21 When drafting the risk management section of the Guidelines on the system of governance, it was extensively discussed whether to specify the difference between risk tolerance and risk appetite.
- 16.22 The use of the terms is very diverse, and EIOPA discussed whether a Solvency II definition would ensure a common understanding of the meaning of the terms for the purpose of compliance with requirements and ensure a harmonised approach between supervisors. However, the Solvency II terminology could diverge from the undertaking's view of how the terms are to be understood. Furthermore use of the terms with different meanings within the undertaking for internal and regulatory purposes could lead to mistakes and unnecessary risk exposure.

- 16.23 Another option discussed was for EIOPA to respect the use of the terms as currently employed by undertakings while ensuring that for the purpose of compliance with regulatory requirements there is no ambiguity as to what is meant by the terms. This would still require the necessity for discussions between undertakings and supervisors to verify that the terms are used as understood under Solvency II and not as internally used and defined by the undertaking itself.
- 16.24 The last option discussed was for EIOPA not to try and define the terms nor clarify the terminologies at all which would give the undertakings the possibility of not changing their current definitions of risk tolerance and risk appetite. This option though, would give the undertakings considerable uncertainties with regard to compliance with requirements as set out in Solvency II. Additionally, it would also entail lack of harmonisation between national competent authorities in understanding the terms and could make the communication between undertakings and supervisors more difficult as there is not necessarily a common understanding as to the meaning and usage of the terms.

Issue 2: Whether to develop Guidelines on Prudent Person Principle as part of the System of Governance

- 16.25 The Prudent Person Principle (PPP) is defined in art. 132 of Solvency II but it is closely linked and explicitly mentioned in Article 44 of Solvency II, it was discussed whether Guidelines were needed to specify the requirements and supervisory expectations of this Article and whether the development of Guidelines should be a part of the system of governance.
- 16.26 The reasoning for choosing the option to include PPP is that its application has to be firmly embedded within the undertaking's system of governance. EIOPA believes that undertakings have to put in place a risk framework in which to test the application of PPP in respect of the undertakings investment policy taking into account the fact that the regulatory quantitative limits will no longer apply under Solvency II. Moreover, the definition and regulation of PPP in Solvency II is fairly short and high-level and being aware of, that these requirements encompass substantial responsibilities for undertakings, the lack of guidance would be particularly challenging for undertakings and supervisors alike.
- 16.27 If EIOPA did not develop Guidelines this would give undertakings more flexibility in how to interpret Article 132 of Solvency II. Furthermore, the principle as such - as opposed to its application to insurance undertakings - is not new. Undertakings could fall back on general explanations and understandings of the principle and hence, might not need guidance beyond what is already written. This would also limit the compliance costs, but could give more uncertainty on how to apply the PPP.

Issue 3: Whether to include minimum requirements on derivatives as part of the Guidelines

- 16.28 Derivatives pose a substantial risk to the solvency of undertakings when they are mismanaged and embody particular risks which to a large extent are unique in relation to other asset categories, such as the exposure that goes beyond the principal (amount) invested.
- 16.29 If EIOPA were not to specifically address requirements relevant to the governance of derivatives within these Guidelines, it would provide undertakings with greater discretion to determine what governance practices were necessary for the use of such instruments in relation to their risk profile. Conversely, by EIOPA developing Guidelines undertakings would get more information on the minimum requirements national competent authorities would expect them to comply with in the use of such instruments. Hence, the Guidelines would also encompass descriptions of some specific, but important aspects to ensure compliance with governance requirements when investing in derivatives.
- 16.30 Article 44 of Solvency II requires the risk-management system to at least cover the governance/control of investments and in particular derivatives and other commitments since these are not fully included in the calculation of the solvency capital requirement. Furthermore, Article 132 of Solvency II already states that an undertaking need to identify, measure, monitor, manage, control and report all risks adherent to assets. Thus, knowing that undertakings would be assessed according to certain expectations whether they are set out in Guidelines or not, while still keeping in mind those minimum requirements specifically for certain investments, could put obstacles in the way of using derivatives. Consequently, this could create additional costs for undertakings with regard to organisation of processes and procedures (internal controls and documentation).
- 16.31 EIOPA appreciates that issuing these Guidelines may have an economic impact on undertakings. However, the benefits of having a common understanding of the requirements for the system of governance from the application of Solvency II between undertakings and supervisors are a vital step to ensure a level playing field and the much needed transparency. By keeping the incremental costs of issuing Guidelines in mind the options were extensively discussed and pros and cons were compared in order to find the best solution.
- 16.32 For the option of determining whether EIOPA should make a Solvency II definition of differences between the terms "risk tolerance" and "risk appetite" in order to align the use of these terms on the European level EIOPA discussions where based on the necessity of streamlining the terms. The pro would be a common approach to the use of the terms. The con, however, is that the terms are not new within the financial sector and many undertakings already apply them on a daily basis.

- 16.34 Accordingly, EIOPA decided that instead of giving a Solvency II definition and specify the differences of the terms risk tolerance and risk appetite it would facilitate discussions and understandings between supervisors and undertakings in the long run if characteristics were provided alongside building blocks for the undertakings to decide for themselves how to apply the terms. This ensures that supervisors and undertakings are equally responsible for reaching a common understanding of the use of the terms and limit misunderstandings.
- 16.35 When discussing the necessity of developing Guidelines on PPP as part of the system of governance EIOPA decided that since the application of the principle for insurance undertakings is a requirement in Solvency II without any quantifiable thresholds for investments there is a strong link to the risk management system. Accordingly, the development of a separate set of Guidelines was discarded on account of the reference in Article 44 of Solvency II and the significant link between risk management and investment policies.
- 16.36 Further, EIOPA received remarks from stakeholders during informal consultations and informal suggestions that some stakeholders were unsure what the principle entails. E.g. PPP does not mean "anything goes". In order to ensure and promote a common understanding among supervisors and undertakings as to what the principle and its requirements are, EIOPA developed these Guidelines. The Guidelines cover investment risk management, assessment of non-routine investment activities, investments in unit-linked and index-linked contracts and finally on the use of securitised assets and assets not admitted for trading on a regulated market to ensure a minimum level of harmonisation and understanding of the principle as well as the close link to risk management.
- 16.37 In a similar context the option of developing Guidelines on the use of derivatives was discussed. Knowing that undertakings would be assessed according to certain expectations regarding the use of derivatives whether they are set out in Guidelines or not, and taking into account that new requirements could put obstacles in the way of using derivatives and create additional costs for undertakings with regard to organisation of processes and procedures (internal controls and documentation), EIOPA found that providing Guidelines would meet the objectives of Solvency II more effectively and efficiently and provide for a better understanding of allocation of capital resources.
- 16.38 Furthermore, by ensuring a more common understanding of the use of derivatives and the risks they impose, undertakings could enhance policyholder protection while improving the international competitiveness of the insurance sector due to a common basis for investment strategies and better capital management.
- 16.39 Accordingly, EIOPA decided that Guidelines should be developed to ensure focus on the increased use of derivatives by undertakings but be kept to a minimum to ensure the flexibility as provided by the PPP. Guidance on how to handle investments in derivatives focuses on the importance of this issue being addressed in the policy on risk management and that undertaking can demonstrate and document how derivatives are used to contribute to a reduction of risks or as risk mitigation technique.

VI - Comparing the Options

16.40 The cost and benefits of introducing Guidelines can be summarised in the following breakdown:

Undertakings

16.41 Additional costs for undertakings can be valued on a minor scale compared to those introduced by the Solvency II:

- Specifying certain terms used in Solvency II, like risk tolerance and risk appetite, does not affect costs when applying the Guidelines;
- The prudent person principle is already introduced in Solvency II and by including it in the Guidelines the specification on how to apply the principle facilitates the use of the principle for undertakings as it clarifies supervisory expectations;
- The minimum requirements that govern the use of derivatives also help undertakings to better understand what is required of them when engaging in the use of derivatives as part of their investment strategy.

16.42 Undertakings would gain benefits from the Guidelines:

- They still leave undertakings with the freedom to organise themselves as they think is appropriate while making some of the principles and requirements clearer in order to facilitate compliance with Solvency II requirements;
- The Guidelines give the basis for a common European understanding for all undertakings about the relevance and requirements of governance, thus strengthening the soundness and transparency of the market and promoting good practices across Member States;
- Since they clarify supervisory expectations, they can facilitate the communication between undertakings and supervisory authorities, helping undertakings to avoid the possible costs of revisions following a supervisory review.

Supervisory Authorities

16.43 From the perspective of the supervisory authorities, the largest part of costs related to the System of Governance requirements arises directly from Solvency II. Nevertheless, there are some costs related to the Guidelines where the undertaking has the freedom to decide what is best for them. This entails the necessity for supervisory authorities of making sure that they understand each undertaking's specific way of doing business in terms of how they are organised, how they define their investment strategy and how they apply terms not defined by Solvency II.

16.44 However, supervisory authorities will also benefit from the interaction needed since it gives them a better insight into how the undertakings work in practice.

Policyholders

16.45 The indirect costs of introducing Guidelines on the system of governance could, at least to some extent, be transferred from undertakings to policyholders, depending on the market conditions prevailing in each Member State. However, EIOPA believes that no direct costs are expected for policyholders stemming directly from these Guidelines. Policyholders will benefit from the sounder governance and higher level of transparency associated with the Guidelines that ensures better policyholder protection.

- 16.46 In conclusion, EIOPA believes that the application of the proposed Guidelines ensure a harmonised and comparable basis for undertakings' risk and capital management as well as for the risk-based supervisory assessment.
- 16.47 Moreover, EIOPA is convinced that the application of these Guidelines will ensure common understanding and a level playing field within the internal market.

17. ORSA

I - Procedural Issues and Consultation of Interested Parties

- 17.1 The Impact assessment was prepared in the course of the policy drafting process, with the contribution of experts from different national competent authorities and EIOPA.
- 17.2 Stakeholders were pre-consulted in the preparation of the Guidelines.
- 17.3 This Impact Assessment is based on the Issues paper from 2008, and comments received from public consultation (for the comments received from stakeholders responding to this consultation visit EIOPA website³).
- 17.4 A feedback statement was issued to inform stakeholders of the understanding from EIOPA on the ORSA as well as how EIOPA interpreted the requirements in the draft Solvency II proposal from 2008⁴.
- 17.5 The focal point of the issues paper from 2008 was the ORSA on the individual undertaking level but after the pre-consultation it became evident that group issues for the ORSA were a major concern for stakeholders. Later on it also became clear that guidance on the interaction between ORSA and partial/full internal models was an important issue that needed to be addressed.
- 17.6 Based on this, EIOPA developed draft Guidelines on ORSA combining individual and group ORSA and addressing their respective specificities as well as issues regarding the ORSA of insurance undertakings using internal models for the calculation of their SCR.
- 17.7 These draft Guidelines were pre-consulted in winter of 2010/2011 with the stakeholders.
- 17.8 The main results of the pre-consultation were that the selected stakeholder groups agreed that the focus of the guidance should be on what needs to be achieved by the ORSA rather than on how it is to be performed. Stakeholders also agreed that the ORSA process is an important process within undertakings as a self-assessment tool for the undertaking and should be left with sufficient room for the individual approach within the undertaking. Undertakings should perform the assessment in accordance with the nature, scale and complexity of their business. It is important that the overall process is internally planned, performed and documented before reporting to the supervisor in order to give the supervisor the most current picture of the undertaking's risk profile and solvency needs. The emphasis should primarily be on the adequacy of the process for providing the AMSB with insight in the risks of the undertaking as well as improving risk management and better understanding the undertaking's solvency needs.

³ <https://eiopa.europa.eu/consultations/issues-papers-surveys-and-questionnaires/index.html>

⁴ https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/Issues-Paper-ORSA-%20Feedback.pdf

- 17.10 It is acknowledged that undertakings should perform the assessment in accordance with the nature, scale and complexity of the risks inherent to their business. Although consulted stakeholders agreed that the proportionality principle is not on different requirements but on different ways to fulfil the requirements they would also prefer more details on the application of the principle. However, as the proportionality principle should be reflected in the process and not on what is to be achieved this made it difficult to address the application of the principle in the previous draft of the guidelines. Efforts have been made in this regard.
- 17.11 After EIOPA decided to publish preparatory Guidelines on ORSA it was necessary to introduce changes to the Guidelines that accommodate the postponement of the Pillar I issues. The changes are not extensive and have been deleted for the application of Solvency II starting 1 January 2016.
- 17.12 A public consultation of the Guidelines and its impact assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' comments were duly taken into account and served as a valuable input in order to revise the Guidelines.
- 17.13 It was agreed to describe policy options not Guideline by Guideline, or group by group of Guidelines, but by areas. In fact, the Guidelines are all strictly linked and interrelated, and analysing them one by one would have ended up in a too fragmented and partial description. It has been judged more appropriate to present directly policy options EIOPA considered, and then offer motivations about the preferred final choice.

II - Problem Definition

- 17.14 Supervisory requirements with regard to risk management vary widely across Member States. These differing requirements impose unnecessary costs on the undertakings and groups and do not provide a level playing field. Therefore new requirements should harmonise and streamline supervisory requirements with regard to ORSA.
- 17.15 From past and current experience with Solvency I it became evident that a formal and harmonised framework for a risk management system, focusing on the identification, assessment, managing, monitoring and reporting of risks, including a forward looking assessment of the undertaking's own risks and solvency needs, was needed and that the Administrative, Management or Supervisory Body (AMSB) had to be more involved in the processes of risk management and the forward looking assessment of the undertaking's own risk and solvency needs. Accordingly, the requirement for the undertaking to perform its own risk and solvency assessment should improve risk and capital management and help align regulatory and industry practice. However, due to some uncertainty regarding supervisory expectations on the ORSA there was a general consensus that harmonised Guidelines were needed.
- 17.16 Regulatory measures will tackle this problem by introducing the Solvency II. However, further details on ORSA are needed to ensure harmonisation and streamline supervisory reporting requirements among Member States.

17.17 Regarding the ORSA, EIOPA has already publicly consulted with stakeholders before the launching of the preparatory phase. After having analysed all comments received during pre-consultation in winter 2010/2011, EIOPA conducted an impact assessment based on issues highlighted by stakeholders. In the public consultation conducted from November 2011 until January 2012 stakeholders did not raise any issues that EIOPA had not already addressed following the pre-consultation, but EIOPA revisited the options chosen and decided that they were still valid. This impact assessment represents a revisit of the previous ones and was amended also in order to illustrate the potential consequences of applying the Guidelines during the preparatory phase.

Proportionality

17.18 National competent authorities are expected to ensure that the provisions are applied "in a manner which is proportionate to the nature, scale and complexity inherent in the business of the insurance and reinsurance undertaking". The approach taken aims to ensure that this expectation can be met, and this is reflected in the drafting of the Guidelines. In most cases, the Guidelines are principle based or drafted with a view to the outcome or supervisory objective that should be met.

17.19 The ORSA is an area where there has been a significant change between the previous regulatory requirements under Solvency I and those under Solvency II.

Baseline Scenario

17.20 When analysing the impact from policies, the methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional public intervention.

17.21 For the analysis of the potential related costs and benefits of the proposed Guidelines on the information to supervisors, EIOPA has applied a baseline on top of which measure additional effects.

17.22 The definition of this baseline is the one provided in the Introduction.

III - Objective Pursued

17.23 EIOPA is of the opinion that undertakings which are well-governed and which, in particular, measure correctly, mitigate and report the risks which they face are more likely to act in the interests of policyholders.

17.24 The aim of the Guidelines on ORSA is to provide guidance to undertakings to apply Solvency II requirements.

IV - Policy Options

- 17.25 EIOPA has identified three policy issues that were considered. The options are based on what EIOPA believes could have the most significant impact on undertakings and the level of protection for policyholders as well as beneficiaries. The focal point is how an underlying problem could evolve, all things being equal, if such options were not decided upon. The policy options described below are not competing with one another, but are proposed as a solution to different aspects of the lack of harmonisation in this area.
- 17.26 During the policy development process the focus was on the main policy questions listed below. On the basis of the following policy questions the ensuing policy issues were considered:
- Issue 1: Whether to provide Guidelines and examples on a ORSA supervisory report;
 - Issue 2: Whether to detail a policy on ORSA;
 - Issue 3: Whether to require a quantitative assessment for all deviations from the underlying assumptions for the SCR calculation regardless of their significance.
- 17.27 The following chapter outlines the additional benefits and additional costs for each issue and the respective analysis. Last chapter recapitulates which options have been preferred and which have been discarded and why.

V - Analysis of Impact

- 17.28 In this section we aim to describe the different issues and the respective expected positive and negative effects from the considered policy issues regarding the main groups of stakeholders. The analysis considers the expected effect on insurance and reinsurance undertakings and groups (undertakings), national competent authorities and policyholders.
- 17.29 As a consequence of the choice of describing issues not Guideline by Guideline, nor group by group of Guidelines, but by areas, it was agreed to give to this chapter a structure symmetric to the structure of the previous chapter. For each issue, arguments are constructed to prepare the selection of the preferred one. In the next chapter, these pro and cons are compared and the final choice.

Issue 1: Whether to provide guidelines and examples on an ORSA supervisory report

- 17.30 It was discussed if the Guidelines should include an ORSA supervisory report, including whether a detailed description or an actual example of a structure and content should be provided to ensure a common baseline and a minimum level of detail.

- 17.31 How an undertaking wants to document the process, procedures and results is very undertaking specific and EIOPA's concerns are that a structured report could influence the reporting of the ORSA. Moreover detailed Guidelines could affect the way the undertaking develops these processes and hence its overall ORSA performance and subsequently the internal documentation and the reporting to the national competent authority. Accordingly, providing a template for a structured report could compromise the undertaking's own assessment. On the other hand, by not providing a structure there might be lack of harmonisation. This non-harmonised structure makes comparison between undertakings as well as information sharing between supervisors and in colleges more difficult.
- 17.32 EIOPA not providing an example on a structured report gives the undertaking the opportunity to design its own reporting template that fits the nature, scale and complexity of the risks inherent in the business of the undertaking and ensures the involvement of the AMSB to develop a template it believes provides sufficient information internally and to supervisory authorities. Additionally, a non-structured report allows the undertaking to use its internal reporting as a basis for the ORSA supervisory report, if deemed adequate by the AMSB.
- 17.33 A main focus is to ensure that supervisory authorities get current information on all ORSA performed by all undertakings.
- 17.34 Based on this EIOPA believes that it would not be helpful to give an example on a structured report, but rather give the undertaking the opportunity to develop its own reporting template for the ORSA supervisory report to ensure the involvement of the AMSB and that it contains what they want reported.

Issue 2: Whether to detail a forward looking assessment of undertakings own risks and solvency policy

- 17.35 A written policy is required by Solvency II for the risk management system and since the ORSA is a part of the risk management system, a policy on this area needs to be included. It was discussed whether EIOPA should define the minimum requirements of this policy.
- 17.36 As EIOPA believes that this assessment is one of the most important processes under the Solvency II regime and as it requires the input from various sources within the undertaking and from external sources as well, it is important that an undertaking ensures that all relevant information is taken into account.
- 17.37 The ORSA policy as part of the risk management system is required in Article 41(3) of Solvency II, should be approved by the AMSB and properly implemented by the undertaking to achieve an effective system of governance.
- 17.38 EIOPA is aware that developing a proper policy that contains the right information to ensure a proper performance of the ORSA could be time consuming. But this policy is required to give insight to and oversight of the decision making process and risk understanding inside the AMSB as well as ensuring the undertaking has a comprehensive picture of all the risks it is exposed to. It also ensures the necessary level of responsibility by the AMSB and a policy will help them in deciding the level of documentation needed, the allocation of responsibilities and workflows and identifying the undertaking's core business with regard to its risk management system as well as what they believe is important for such a process.

17.39 Hence, EIOPA believes it is necessary to set out the policy in such detail as to ensure proper governance and subsequently good results. This is a requirement of Articles 41(3) and 45 of Solvency II, and this particular process requires a higher standard for the internal documentation as well as input for the supervisory report of the ORSA. Accordingly, by requiring such a policy, EIOPA emphasizes that an appropriate level of detail is expected depending on the nature, scale and complexity of the risks inherent to the business of the undertaking.

17.40 With proper processes laid down in the policy the undertaking ensures a better degree of quality for the assessment itself. Vice versa an assessment will be of less quality if important and significant sources of information will be overseen or if the responsibility of the AMSB is not clearly set out in the policy. This will be more costly for the undertaking at the beginning when setting up the policy. But as only good processes for the assessment will lead to good assessments it can be expected that in the long run this will cost less time and resources for the undertaking.

17.41 Therefore EIOPA considers appropriate to develop an ORSA policy.

Issue 3: Whether to require a quantitative assessment for all deviations from the standard formula regardless of its significance

17.42 An assessment of the deviation from the standard formula is required, in order to determine whether the deviation is significant. The question was whether the quantitative assessment of the deviation should be a Guideline to all deviations or only for significant deviations. This would entail that an initial qualitative assessment would be acceptable as an indication for the significance of the deviation.

17.43 EIOPA believes that the most appropriate approach to the assessment of the deviations is to perform a qualitative assessment as a first step, so that undertakings do not have to do a potential burdensome quantitative assessment for all deviations. EIOPA will expect quantification as a second step, only if the qualitative assessment indicates a significant deviation from the assumptions underlying the Solvency Capital Requirement calculation.

17.44 On the other hand, the qualitative assessment of the deviation could be sufficient as a starting point, as quantification may be time consuming and costly and cannot be taken as definite anyway but there is an increased possibility of error, since the qualitative assessment may indicate that the deviation is not significant when in fact it is. EIOPA is aware of that quantification can be rather burdensome.

17.45 EIOPA accepts the error margin and only requires quantitative assessment when qualitative assessment indicates that deviation is significant and will have a material impact.

17.46 The same approach has been taken on the forward looking assessment of undertaking's own risks during the preparatory phase.

VI - Comparing the Options

17.47 EIOPA believes that the Guidelines proposed in those three policy issues help to achieve the objectives pursued in enhancing the protection of policyholders and beneficiaries and improving the international competitiveness of EU insurers and reinsurers, in an efficient and effective way. A specific characteristic of the policy options proposed, which contributes to an effective and efficient result, is that they allow for supervisory practices to be applied in a proportionate manner with respect to risks.

17.48 EIOPA appreciates that issuing these Guidelines may have an economic impact for undertakings. However the benefits of having a common understanding of the ORSA between undertakings and supervisors are a vital step to ensure a level playing field and the much needed transparency.

17.49 The issue n. 1 of whether to provide a structure for the ORSA supervisory report was that EIOPA found it better to give undertakings the flexibility of deciding what they find to be the relevant information that should be documented and disclosed to supervisors. The ORSA can be a very complex process that involves most of the undertaking and it requires the AMSB to be involved in all policies, processes and procedures- especially their risk exposure and how to assess it. Furthermore is an undertaking-specific tool, which has to take into account the nature, scale and complexity and level of documentation undertakings prefer. Consequently, the option of providing a structure for the report was discarded, since it would be difficult to make a one-size-fits-all structure for the supervisory report.

17.50 The issue n. 2 to detail a policy on ORSA has been judged useful to develop a common understanding on how an undertaking should assess its own risks on a continuous basis and how to use this information to ensure good governance within the undertaking.

17.51 Finally, EIOPA valued the issue n. 3 of whether to require a quantitative assessment for all deviations from the standard formula or only when the qualitative assessment showed that there was a significant deviation from the assumptions underlying the Solvency Capital Requirement calculation.

17.53 On this issue EIOPA have accepted the error margin and will only require quantitative assessment when qualitative assessment indicates that deviation is significant and could have a material impact on the risk and capital management.

17.54 The largest part of costs related to ORSA arises directly from preparation to comply with Solvency II. EIOPA Guidelines aim at detailing requirements already introduced by Article 45 of Solvency II, so promoting a harmonized interpretation among undertakings and supervisors. Costs and benefits of EIOPA Guidelines can be summarized as in the following breakdown.

Undertakings

17.55 Additional costs for undertakings can be evaluated of a much minor scale with respect to those introduced by Solvency II:

- The request for a written ORSA policy is a specification of what Solvency II already states for the ORSA under the overall risk-management system (article 41 of Solvency II). Therefore there are no significant costs in relation to the Guidelines for undertakings;
- The same consideration can be valid for the supervisory report, which is required by Articles 35 and 45 of Solvency II, and for which EIOPA decided not to set a predefined structure, but rather give the undertaking the opportunity to develop its own appropriate format;
- As for deviations from assessments based on the standard formula, also in this case EIOPA opted for a balanced interpretation of Solvency II, asking for quantification only in the case a first qualitative analysis indicates that the deviation is significant;
- The group-perspective applies *mutatis mutandis* and EIOPA just specified this perspective for the ORSA, at the same time allowing the national competent authority of subsidiaries to require a translation into its language of the part of the group information regarding the entity concerned (when different from the language of the group in which the document for the ORSA is written);
- The decision to perform an ORSA at least annually (if no other relevant changes happen in the meanwhile), though a specification added by EIOPA, aligns to the normal frequency undertakings have to respect for budget purposes and capital requirement calculations;
- Finally, EIOPA Guideline to record each process or the ORSA and produce an internal ORSA report, to favour sharing information within the undertaking, should be seen as a straightforward consequence of the request in Solvency II to insert the ORSA in the overall risk-management system with a management benefit for the understanding.

17.56 In front of minor additional costs arising from EIOPA Guidelines, undertakings would gain benefits:

- Help in organising ORSA processes and linking it to the other parts of governance;
- Prevent possible errors in the risk management and solvency needs and therefore costly adjustments for the undertaking;
- Give the basis of a common European understanding for all undertakings about the relevance of risk management and solvency needs, strengthening soundness and transparency of the market, and promoting best practices across countries;
- Can simplify the interactions between undertakings and supervisory authorities, so allowing avoiding costs connected to other supervisory review and / or possible revisions of the regulation set.

17.57 All possible costs arising from the Guidelines have an on-going nature, related to the periodical assessments.

Supervisory Authorities

17.58 Also on the side of supervisory authorities, the largest part of costs related to the forward looking assessment of undertaking's own risks arises directly from Solvency II. In particular, Authorities will be asked to analyse, at least year by year, supervisory reports, in order to verify, for each undertaking, overall solvency needs and possible effects of deviations from the underlying assumptions of the standard formula.

17.59 Cost added by EIOPA Guidelines can be considered of a much minor scale. However, the choice not to give a unique predefined template to the supervisory report can, at least to some extent, complicate the functions of national competent authorities. The same consideration can be repeated also for the choice to require quantitative evaluations of deviations from the standard formula not in every case, but only when a qualitative analysis has indicated possible significant differences. This option could imply more attention by national competent authorities in verifying qualitative arguments proposed by undertakings.

17.60 In front of these minor additional costs, authorities will surely benefit from the overall package of Guidelines by gaining a far better inside in the risk and capital situation of an undertaking. Moreover, the forward looking perspective can serve as an indicator of future supervisory reviews and measures. Assuring that supervision and controls will apply to a more homogeneous and harmonized set of regulation within each country and across countries is another benefit from the Guidelines. The functions of national competent authorities will be simplified, favouring cooperation among supervisors and, as for undertakings, the emergence of best practices.

17.61 Also on the side of national competent authorities, costs arising from the Guidelines have an on-going nature, related to the periodical assessments.

Policyholders

17.62 While the overall costs of implementing the ORSA could be, at least to some extent, transferred from undertakings to consumers depending on market conditions prevailing in each country, no additional costs are expected for consumers directly from EIOPA Guidelines. Consumers will surely benefit from the sounder governance and the higher level of transparency associated with formal own risk assessments, well inserted inside the overall risk-management system.

17.63 EIOPA believes that the application of the proposed Guidelines ensures a harmonised and comparable basis for undertakings' risk and capital management as well as for the risk-based supervisory assessment. Moreover EIOPA is convinced that the application of these Guidelines will ensure common understanding and a level playing field.

Supervisory Review Process

18. Supervisory Review Process

I - Procedure Issue and Consultation on Interested Parties

18.1 The content of this impact assessment document was informally considered and developed as the guideline paper on the Supervisory Review Process was being discussed and developed by both the IGSRR Subgroup 3, which was focused on the solo elements of the paper, and the IGSC Groups SRP Taskforce, which was focused on the group elements of the paper. This specific impact assessment document has recently been more formally compiled now that the SRP paper is almost finalised and is soon to be presented to the EIOPA Board of Supervisors (BoS) and the main policy questions related to the paper identified.

Background

18.2 The Directive outlines in article 27 that the main objective of supervision is the protection of policyholders and beneficiaries and in that regard it says that supervisory authorities should have the necessary means and relevant experience, capacity and mandate to ensure this objective is achieved. The level 1 also says, in article 29, that supervision must be risk based and prospective, include verification on a continuous basis, using an appropriate mix of offsite activities and onsite inspections, of undertaking's compliance with the directive and that the requirements of the directive should be applied in a proportionate manner. It requires, in article 28, supervisory authorities to consider the impact of their decisions, including those related to supervision, on the stability of the financial system in the EU particularly in emergency situation. And finally, in article 34, the level 1 says that supervisory authorities should have the powers to take necessary preventive or corrective measures to ensure undertakings remain compliant with relevant laws, regulations and administrative provisions.

18.3 In article 36, which is concerned more specifically with the supervisory review process (SRP), the level 1 indicated that the SRP should include the review and evaluation of the systems, processes and reporting procedures established in undertakings designed to comply with the directive. It should also include the assessment of the risks facing or that may face undertakings and the ability of the undertaking to assess those risks itself. Article 31 introduces the need for transparency in relation to criteria, methods and tools used by supervisory authorities in the SRP.

- 18.4 These are the baseline requirements of level 1 in relation to supervision and the SRP under Solvency II and there are no specific requirements relating to the SRP in level 2.
- 18.5 Based on these requirements EIOPA decided to develop a L3 guideline paper on the high level process to be followed when conducting the SRP so as to contribute to the convergence in approach to SRP amongst national supervisory authorities (NSAs) without over prescribing the process, particularly in the early stages of implementation of Solvency II, which could risk mechanising the process and compromising the application of risk based and proportionate supervision by failing to recognise the specificities of individual markets and undertakings.

II - Problem Definition

- 18.6 In the absence of any EIOPA Guidelines on SRP, national supervisory authorities would need to decide how to structure themselves and develop their own operating model in order to ensure they meet these requirements. This could mean that the operating model implemented from one EU market to another could vary significantly and that may result in very different approaches by different NSAs potentially leading to different supervisory approaches for undertakings from one market to the next and potentially inconsistent treatments of different undertakings within the same group e.g. very different risk assessment processes, different approaches to the conduct of offsite activities and onsite inspections, different levels of communication and information sharing between undertakings and their supervisory authorities, different approach to the use of supervisory powers and the implementation of supervisory measures, negative consequences for cross border groups, etc.
- 18.7 The lack of a standard approach to SRP across EU/EEA might result in different levels of supervision of undertakings and by extension protection afforded to policyholders as a result.
- 18.8 In such a scenario the SRP may also be quite non-transparent to undertakings and therefore they may not know what to expect in terms of their supervision. This would be particularly difficult in the case of groups operating in multiple EU markets and could give rise to unnecessary compliance costs.
- 18.9 Another potential problem arising from a scenario where NSAs develop different operating models resulting in different approaches or levels of supervision is that undertakings may try to arbitrage between regulatory regimes within the EU putting policyholders at risk.

Power & Rational

18.11 In addition to the objective of avoiding the problems mentioned above and considering the appropriateness of and the power to develop guidelines on the SRP, EIOPA has responsibilities arising from its establishing regulations which oblige it to, amongst other things:

- Contribute to high quality common regulatory and supervisory standards, practices and culture;
- Ensure consistent efficient and effective application of legally binding EU law, including Solvency II;
- Prevent regulatory arbitrage;
- Ensure effective and consistent supervision of financial institutions in the EU.

18.12 The lack of an EU/EEA standard framework for SRP means that NCA's would not have a commonly agreed model for meeting the objectives of supervision under Solvency II and need to develop their own models for achieving that. This would introduce a potential for very significant variation in approach from one NSA to another and even between supervisory teams within a single NSA where there is no standards approach to the SRP of undertakings. This could compromise application of consistency in SRP which is particularly relevant in a group context.

18.13 These are the main reasons and powers for the development of this EIOPA Guidelines paper.

III - Objective Pursued

18.14 The objectives pursued in developing this paper are consistent with some of the high level objectives set for the overall Solvency II project including:

- Ensuring better regulation,
- Deepening the integration of the EU insurance market,
- Enhancing policyholder protection,
- Advancing supervisory convergence and cooperation,
- Increasing transparency,
- Promoting international convergence.

18.15 Linked to these high level objectives EIOPA's paper on the supervisory review process more specifically aims at:

- Ensuring appropriate supervision under Solvency II aimed at achieving the main objective of supervision i.e. protection of policyholders and beneficiaries;
- Promoting common regulatory and supervisory standards, practices and culture using a step by step approach and beginning with high level process;
- Establishing a high level process, to be applied in conjunction with other standards and guidelines and best practices, in order to achieve a risk based, forward looking and proportionate approach to supervision across the EU while avoiding over-prescription or

- premature convergence in SRP which may jeopardise risk based and proportionate supervision of undertakings;
- Ensuring transparent and consistent supervision of the insurance and reinsurance industry in the EU, both in terms of individual undertakings and groups.

IV - Policy Options

18.16 EIOPA has identified 3 main policy issues which were considered and debated during the development of this paper and they include:

Policy Issue 1: The level of flexibility within the process as a whole

18.17 Concerning this issue, two alternative options have been investigated:

- I.** Guidelines containing a fixed step by step process for the conduct of the SRP which all national supervisory authorities would need to follow for all undertakings;
- II.** Guidelines containing a high level process setting out the stages to be followed and elements to be included in the SRP by all NSAs but leaving flexibility for NSAs.

Policy Issue 2: The level of detail included in the guidelines on risk and impact assessments

18.18 Concerning this issue, two alternative options have been investigated:

- I.** Include further specific criteria and metrics for assessing the impact and risk classifications of undertakings within the Guidelines;
- II.** No specific metrics or criteria to be provided in the Guidelines, but provide guiding examples and explanations in the explanatory text.

Policy Issue 3: The level of detail included in the guidelines on supervisory consequences arising from the outcome of the Risk Assessment Framework

18.19 Concerning this issue, two alternative options have been investigated:

- I.** No details in the guidelines meaning that the process is defined but it allows flexibility in terms of the detailed review activity or supervisory measures to be taken in each particular situation;
- II.** Description of possible spectrum of detailed review activity or supervisory measures to be taken included in the guidelines or annex.

Each of these issues is explored in detail below.

18.20 For the analysis of the potential related costs and benefits of the proposed Guideline on the information to supervisors, EIOPA has applied a baseline consisting in the combination of the Directive and the Implementing Measures plus any eventual enhancements already reached by Countries in the application of future SII requirements.

18.21 In particular, the definition of the baseline is the one provided in the Introduction.

V - Analysis of Impact

Policy Issue 1: The level of flexibility within the process as a whole

Option 1

18.22 Guidelines containing a fixed step by step process for the conduct of the SRP which all national supervisory authorities would need to follow for all undertakings. This would need to be designed to meet the objective of supervision for undertakings that represent the highest risk to beneficiaries and the market (both in terms of risk and impact) and thereafter to be applied to all undertakings.

Analysis of Impact of Option 1

On policyholders:

18.23 There would be the indirect impact of higher cost on NSA's to develop and operate a one size fits all SRP which defaults to a level of engagement appropriate for the supervision of high risk undertakings (in terms of both impact and risk). The cost, firstly arising to the NSA, would be passed on to undertakings (UTs) i.e. through levies, charges, or other means and thereafter further passed on to policyholders (PHs) through increased premiums from undertakings. That said, the cost of developing a one-size-fits all could be reduced in comparison with each NSA developing its own process and tools but there is still expected to be a high cost associated with supervising at that level of engagement for all UTs on an on-going basis. This is expected to be an initial and ongoing negative impact.

18.24 Expected impact of lower protection afforded to PHs where a standard, fixed and inflexible SRP is applied by all national supervisory authorities (NSAs) to all UTs. This is likely to compromise the application of risk based and proportionate supervision (requirements of the Directive) by reducing supervisory capacity to focus on riskier UTs and riskier parts of UTs since the process to be applied should be the same for all UTs. It would also diminish the capacity of supervisors to react quickly to crisis situations if they need to strictly follow the process and that is likely to result in lower protection for PH. Finally it would also reduce the ability of supervisors to apply supervisory judgement in a proportionate manner. These are expected to be an ongoing negative impact.

18.25 Potentially higher protection afforded specifically to PHs of lower risk (impact & risk) UTs where the same process is to be followed for those as for all other UTs. Although it is questionable whether there would be a real benefit to such intensity of focus or engagement. Limited positive impact which is considered to be ongoing.

On industry:

18.26 Higher cost for NSAs to develop a one size fits all SRP where the same level of supervisory engagement is applied for low impact & low risk UTs as for high impact & high risk UTs as this would result in more resources needed in NSA, for example, more staff or technology costs, etc. and this cost would be passed on to UT's through levies, charges, or other means. This is likely to be an initial and ongoing negative impact.

18.27 Potentially less effective, risk based and UT focused supervision by NSAs (i.e. may be more of a mechanistic or tick box approach applied) where a strict process for SRP must be followed by NSAs for all UTs. Impact for industry of this could include; less entity specific input / direction / guidance for UTs by NSA's as might otherwise be provided in a situation where undertaking or market specificities can more easily be considered. This is likely to be an ongoing negative impact.

18.28 Potentially more intensive supervision than in policy options 2 & 3 for some UTs e.g. lower impact and risk category UTs, because the same approach to SRP would be applied to all UT and less ability to apply a proportionate approach or proportionate requirements e.g. it might result in more regular reporting of RSR than might be appropriate, more intensity of onsite/offsite activity applied for lower risk/impact UTs than is appropriate, more requests for activities by UTs than might be necessary e.g. regular stress tests, etc. This is likely to be an ongoing negative impact.

18.29 Under this option there is likely to be a slower reaction by NSAs to actual or perceived weaknesses or deficiencies because all steps of the process must be followed in a strict process flow. The impact of this could be that UTs are not notified quickly of what/if any measures are to be taken to rectify situations. This would be an ongoing negative impact.

18.30 A benefit of this option is considered to be that it would promote consistency in detailed approach by NSAs so that industry would know clearly what is expected of all UT's within markets and from one market to market. This would be particularly beneficial in the case of a group where the same approach from NSA's can be expected from one EU market to another. That said groups are unlikely to want consistency in supervision to an extent that it undermines the application of proportionality, as would otherwise be appropriate, in the supervision of its subsidiaries. This would be an ongoing positive but limited impact.

On national supervisory authorities:

- 18.31 High costs for NSA's to implement and operate a supervisory system that applies to all UT's and will address the supervision needs of the highest impact and risk category UT's in the EU/EEA (not just the highest in their own market). Example being a model requiring the application of the full process with its full rigours even to a low impact / low risk UT. This would be an ongoing negative impact.
- 18.32 The inability for NSA's to adapt the SRP to fit its specific market and the specific risks posed by individual UT's, both in terms of designing the model in general and adapting it as necessary when conducting the SRP for a specific UT's, would have the impact of reducing the possibility for NSA's to achieve the objectives of supervision under SII, including, protection of policyholders, risk based and proportionate supervision, etc. This is considered to be an ongoing negative impact.
- 18.33 A completely consistent approach to the SRP for all UT's and across all Member States allows for the potential duplication of (or sharing of information/experiences on) operating models between NSA's. This lends itself to more easily meeting the objective of consistency in SRP and is particularly beneficial in a group scenario. Also this level of consistency allows NSA's in a college to better co-ordinate their activity and communicate the results of same. This is considered to be an ongoing positive impact.

Option 2

- 18.34 Guidelines containing a high level process setting out the stages to be followed and elements to be included in the SRP by all NSAs but leaving flexibility for NSAs to apply supervisory judgement and take account of undertaking and national specificities in order to ensure that risk based and proportionate supervision is maximised.

Analysis of Impact of Option 2

On policyholders:

- 18.35 Provides confidence to PHs that a consistent and robust approach to SRP of UTs is being adopted by all EU/EEA NSAs but not an approach that ignores the specificities of individual markets and UTs - thereby contributing to the main objective of SII of policyholder protection but in a risk based and proportionate manner. Example: Guidelines 1, 2, and 8 emphasise the need for the process to be followed in a consistent way which is properly governed within the NSAs but Guidelines 3 and 4 (and Guideline 1 as well) emphasise the need for flexibility, supervisory judgement and proportionality. This is considered to be an ongoing positive impact.

18.36 Less costly for NSAs, and thereby indirectly for PHs (through charges on industry which converts to premiums on PHs), than option 1 because NSAs are not implementing a fixed EU model which defaults to the highest level of supervision for all UT but instead they have flexibility NSAs to design and implement a standard high level process in a way that best suits the specifics of its market e.g. the profile of undertakings in its market, any specific types of business that occurs there, etc. This is also expected to compare positively to option 3 as under this option there will be the capacity for NSAs to share experiences and replicate the operating model (or relevant parts of the model) of other NSAs while also allowing flexibility to ensure the model as adopted fits its own market. This is considered to be an initial and ongoing positive impact.

On industry:

18.37 Provides a level playing field with respect to SRP of UT's throughout EU/EEA but via an approach which allows consideration of market and undertaking specificities in terms of, for example, impact metrics, key risk indicators, outcomes for RAF, etc. thereby contributing to objective of risk based and proportionate supervision. Also consideration of UT specificities is facilitated through emphasis of the need for appropriate ongoing communication between NSA and UT throughout the SRP. This is considered to be an ongoing positive impact.

18.38 A clear, transparent and published approach to SRP for all UT's in EU/EEA, without being over prescriptive or imposing strict rules, improves the level of information available to industry and contributes to managing industry's expectations of supervision with regard to each stage of the process. Examples: the information required for supervision, the type and approach to RAF, the content and focus of supervisory plan, the elements within and the process to be followed for the conduct of detailed review and supervisory measures, etc. This is considered to be an ongoing positive impact.

18.39 Some flexibility within a standard high level EU/EEA framework enable NSA's to focus their attention on the riskier UT's and the riskier parts of UT's i.e. discourages too much attention being focused on lower impact/risk category UT's while facilitating appropriate attention being focused on the higher impact/risk category UT's. Example: GLs 1, 3 and 4 recognise need for flexibility, emphasise principle of proportionality throughout and highlight need for supervisory judgement as appropriate. This is considered to be an ongoing positive impact.

18.40 Initial costs for NSA's, to develop or adapt their systems to be compliant with HL SRP, passed on to UT's. However this cost would also happen in a non-harmonised approach. This approach allows for reduction of costs for groups operating in more than one MS. This is considered to be an initial impact but not of significance by comparison to the other options considered.

18.41 In such a regime it would be possible to apply proportionality taking account of the different markets size and specificities. Example: Criteria on size and risks that are specific to particular market could be used within the overarching process which should be consistent market to market. The impact is considered to be generally positive and overtime these criteria are expected to become more aligned across markets (but not in a forced way or too soon) as NSAs become more experienced in applying the consistent process and sharing experiences and best practices. Considered an ongoing positive impact.

On national supervisory authorities:

18.42 Combining a structured process with some flexibility is likely to be the most effective way to achieve the objectives of supervision as per the Directive. This is considered to be an ongoing positive impact.

18.43 Initial costs of adapting national supervisory system to be compliant with HL SRP. However costs associated with adapting individual NSA systems to meet the requirements of the Directive (risk based, proportionate SRP, considering all elements highlighted in A36, etc.) are expected to arise on an individual SA basis in any case so the costs to adapt to an EU/EEA standard high level process may not be that significant and there may be possibilities to share information experiences on operating models across markets which could also reduce costs for individual NSAs. This is considered to be an initial negative impact but compares favourably to the same impact for the other options.

18.44 Having an EU/EEA standard framework provides guidance and a benchmark for NSA's as to a commonly agreed model for meeting its objectives of supervision under SII whilst also allowing NSA's sufficient flexibility to adapt the model to specificities of local market. This is considered to be an ongoing positive impact.

18.45 Existence of a standard framework within EU/EEA facilitates NSA's leveraging the experience / existing practices of other NSA's and sharing best practices and learning from one another not just at the outset but in the long term. This is considered to be an ongoing positive impact.

18.46 A common structured process with some flexibility facilitate cooperation and communication between supervisors, in particular in a group scenario, resulting in effective supervision, without undermining main goal of protection of policy holders. Example: The High Level Diagram identifies specific times when it is appropriate for SAs, supervising UT's that are part of a group, to communicate with the college regarding elements of or outcomes of the SRP e.g. in relation to the supervisory plan or supervisory measures. This is considered to be an ongoing positive impact.

Policy Issue 2: The level of detail included in the guidelines on risk and impact assessments

Option 1

18.47 Include further specific criteria and metrics for assessing the impact and risk classifications of undertakings within the Guidelines.

On policyholders:

18.48 While recognising that defining metrics and criteria in the guideline could be beneficial to policy holders in terms of transparency, EIOPA believes that putting metrics and criteria in the Guideline could limit supervisory judgement through reducing the supervisory flexibility when seeking to deliver a proportionate approach to supervision, because the supervisory approach would be more strongly and strictly directed by the Guideline. This could lead to a negative impact on policyholders on an ongoing basis, as the supervisory actions would not be able to take account of the individual nature of each issue (e.g. a lack of sensitivity within categories of risk).

18.49 The supervisory burden may become disproportionate, leading to higher costs to policyholders. For example: for small UTs the regulatory burden may increase, as all metrics and criteria will apply, whereas for large insurers the regulatory burden may reduce. PHs of small insurers may therefore be disadvantaged. This could lead to a negative impact on PHs, due to lack of proportionality, on an ongoing basis, as the supervisory actions would not be able to take account of the individual nature of each UT.

18.50 The diverse nature of the insurance industry means that developing metrics and criteria to cover enough situations will result in a large number of them. This will be confusing for supervisors and may lead to issues with UT being missed. Policyholders are likely to suffer if UTs do not receive appropriate supervisory actions in a timely manner. This is considered to be a negative impact on an ongoing basis.

On industry:

18.51 Inappropriate criteria if applied to a market, undertaking or Group could in practice result in either disproportionate supervision e.g. either too intensive or insufficient supervisory focus, or, an inappropriate approach e.g. supervisors focusing on the wrong areas within an UT. This is considered to be a negative impact on an ongoing basis.

18.52 It could also lead undertakings themselves to focus too intently on the highlighted criteria and metrics, and ignore or not consider other metrics relevant to their business. For example; having predefined metrics and criteria may not lend themselves to small or specialist sectors or lines of business, so UTs may be confused about how supervision will work. This is considered to be a negative impact on an ongoing basis.

- 18.53 Predetermined criteria and metrics means there is less flexibility for NSAs to select those that best suit its market which in turn could result in less effective and undertaking or market focused supervision. This is considered to be a negative impact on an ongoing basis.
- 18.54 Deeper understanding and greater certainty of the supervisory approach should enable UT to manage their relationship with their NSA more effectively. This is particularly relevant for Groups as it also enhances greater consistency of supervision of undertakings between NSA that are part of a Group. This is considered to be a positive impact on an ongoing basis.

On national supervisory authorities:

- 18.55 An over prescription, within the guidelines, of how to conduct and what to consider in the risk and impact assessment could lead NSAs to apply a mechanistic approach which would be inappropriate for a risk-based and forward looking supervisory regime. This is considered to be a negative impact on an ongoing basis.
- 18.56 If there are prescribed metrics, criteria and methodologies, there is a risk that supervisors will fail to pay adequate attention to risks or issues that fall outside the predefined norm. This is considered to be a negative impact on an ongoing basis.
- 18.57 The diversity of the insurance industry through the EU means that it will be very difficult to provide an appropriate and complete list of metrics and criteria for all UTs or situations. Therefore it is likely to lead to difficulties for NSAs to fully comply with the Guideline text. This in turn would require NSAs to dedicate resources to explaining such non-compliance (under the "comply or explain" mechanism) and thereby affecting the efficiency of NSAs. For example, if NSAs did defer from a prescriptive guideline (which is likely), they would need to formally explain their departure which in many cases would be appropriate and justified as it would be responding to national specificities. This is considered to be a negative impact on an ongoing basis.
- 18.58 NSAs will need to get some experience of the SII supervision approach in order to identify/develop the most appropriate metrics or criteria for the entire EU region, so including metrics and criteria in the guidelines at this stage would be premature. This is considered a negative impact of this option at the initial stages of Solvency II implementation.
- 18.59 Consistency in the criteria, metrics and methodology can be seen as beneficial within the supervisory authority, or between supervisors within a Supervisory College. This is considered to be a positive impact on an ongoing basis.

Option 2

18.60 No specific metrics or criteria to be provided in the Guidelines, but provide guiding examples and explanations in the explanatory text.

On policyholders:

18.61 This option potentially allows for more appropriate risk based and forward looking supervision across the EU due to NSAs having, within an overarching EU consistent framework, the flexibility to select the impact and risk classification approaches that are most appropriate for their market and industry at a point in time and therefore apply the most effective supervisory approach for that market and enable supervisory focus on the areas most needing attention locally, thereby ensuring the appropriate protection of policy holders. This is considered to be a positive impact on an ongoing basis.

18.62 This option best facilitates the application of a proportionate approach to the risk and impact assessments of UT, by ensuring that market specific criteria and metrics are considered, and as such should best facilitate policyholder protection. This is considered to be a positive impact on an ongoing basis.

18.63 It provides confidence to PHs that a broadly consistent approach will be used by NSAs to assess undertakings as to the protection of PHs across Member States, whilst ensuring that the specificities of individual markets and UT's can be taken into consideration and addressed by NSAs themselves. This is considered to be a positive impact on an ongoing basis.

18.64 Allowing examples to be given only in the explanatory text regarding appropriate approaches of NSAs to impact and risk assessment, rather than being explicit and more directional through an EIOPA Guideline, ensures there is flexibility so that different approaches can be used by different Member States to cater for national specificities. This increases confidence for PHs that the UT is appropriately supervised. This is considered to be a positive impact on an ongoing basis.

18.65 However this option may not promote as transparent or consistent an approach to risk and impact assessment within a market (although it does not necessarily preclude NSAs being transparent regarding criteria or metrics for their markets) or across EU markets as option 1 would. This is considered to be a negative impact on an ongoing basis.

On industry:

- 18.66 The option to include details about the criteria and metrics in the explanatory text, as opposed to in the Guidelines themselves, seeks to promote a level playing field with respect to risk and impact assessment of UT's throughout EU/EEA but via an approach which allows consideration of market and undertaking specificities thereby contributing to the objective of risk based and proportionate supervision. For example, the assessment of risk can be adapted for the particular structure and location of a group making cross border supervision potentially more consistent. This is considered to be a positive impact on an ongoing basis.
- 18.67 The flexibility in the explanatory text enables NSA's to use their judgement when determining how to ensure they focus their attention on the riskier UT's and the riskier parts of UT's and thereby not applying too intensive supervision over lower impact or risk category UTs and enabling appropriate supervisory attention on the higher impact or risk category UTs. This ensures a more level playing field for UTs in terms of the impact of supervision. This is considered to be a positive impact on an ongoing basis.
- 18.68 The lack of specification of particular criteria and metrics means that NSA's must actively consider and identify those that are appropriate to their market, thereby facilitating more market and undertaking specific supervision. This is considered to be a positive impact on an ongoing basis.
- 18.69 There may be actual or perceived inconsistencies in the approach to supervision (e.g. the depth and frequency of supervision) by NSA's resulting from different impact and risk classification approaches selected by each NSA such that industry may not know what to expect due to the Guideline being high level and not specifying the specific approach. This may be particularly evident in the case of Groups that have undertakings in various Member States. This is considered to be a negative impact on an ongoing basis.

On national supervisory authorities:

- 18.70 Having flexibility in the Guidance with examples in ET means that NSAs are able to adjust for local context, whilst maintaining a broadly consistent approach to risk and impact assessment across the EU. This is considered to be a positive impact on an ongoing basis.
- 18.71 This option allows for more risk based and prospective supervision, as is required by level 1, due to NSA's having the flexibility to select, and adjust as the case may be, the impact and risk classification approaches that are most appropriate for their market and industry and as a result facilitate a more effective supervisory approach for that market. It also enables supervisors to focus on the areas most needing attention within undertakings and their market in general. This is considered to be a positive impact on an ongoing basis.

- 18.72 It also provides the necessary flexibility to enable a proportionate approach to supervision. This is considered to be a positive impact on an ongoing basis.
- 18.73 An EU/EEA standard framework, as provided for in this option, that allows flexibility in its application by NSAs permits, but does not require, them to leverage the experience / existing practices of other NSAs and facilitates NSA's sharing best practices and learning with one another. This is considered to be a positive impact on an ongoing basis.
- 18.74 Not placing further detail about impact and risk classification approaches within the guidelines ensures that the approach of NSAs can be informed by actual experience of Solvency II and that any explanatory text can be appropriately and quickly adjusted. This flexibility also enables broader consultation, in a live Solvency II environment, between senior supervisors about what they feel are the best indicators and how such indicators could be used to direct supervisory resources, when used together with the risk classification. This is considered to be a positive impact on an ongoing basis.
- 18.75 There may be higher costs if NSA's implement and operate a supervisory system that, as a result of them not receiving sufficient guidance by way of the Guidelines or examples, fails to provide them with the necessary information to make appropriate judgements and results in them applying inappropriate impact and risk classification approach and thereby deciding on deeper and more frequent supervision for all UT's than is necessary. On the other hand, a system that does not take account of criteria and metrics that are appropriate for individual market could have the same impact in terms of resulting in supervisory attention being inappropriately directed. This is considered to be a marginally negative impact of this option on an ongoing basis.
- 18.76 Supervisory colleges may find it more difficult to discuss risk assessments under this option as the level of convergence will be more high level. NSAs may approach risk and impact assessment so differently that there is no comparison possible. Inconsistencies between criteria and measures, selected by the supervisory authorities, may result in comparisons between NSAs difficult, including during peer reviews. This is considered to be a negative impact on an ongoing basis.

Policy Issue 3: The level of detail included in the guidelines on supervisory consequences arising from the outcome of the RAF

Option 1

- 18.77 No details in the guidelines meaning that the process is defined but it allows flexibility in terms of the detailed review activity or supervisory measures to be taken in each particular situation.

On policyholders:

- 18.78 At the expenses of potentially less convergence, higher protection for PHs

since the further supervisory activities or measures are not taken in an automatic way but tailored to the real PH needs, on a case by case basis. This flexible approach minimises the likelihood of misjudgements and therefore represents more protection of policyholders which is in line with the main objective of supervision under Solvency II. This is considered to be a positive impact on an ongoing basis.

18.79 Since supervision under Solvency II is new, clear rules cannot be defined before some experience of operating under Solvency II is gained. At that point further convergence will be possible and promoted. This is considered to be a positive impact on an ongoing basis.

18.80 Potentially less transparency in the consequences of the outcome of the RAF and less convergence of outcomes among Europe in the short term. This is considered to be a negative impact on an ongoing basis.

On industry:

18.81 Since the decision on further supervisory activities to be carried out and on the eventual measures to be taken, if necessary, may depend on the situation and undertaking concerned, a less detailed and less mechanistic approach allows the supervisor to decide the most appropriate actions and the UT benefits from a more specific treatment. Proportionality issues can be better applied under this approach. This is considered to be a positive impact on an ongoing basis.

18.82 The industry may bear costs since the process is less automatic and the consequences of their actions may not be known in advance. On the other hand a more predetermined approach may also be costly since it does not allow for specificities of situation or UTs be considered and therefore might result in excessive actions or measures than are appropriate to that circumstance. This is considered to be a marginally negative impact on an ongoing basis.

18.83 The industry benefits from the fact that further activities or measures are taken in a less mechanistic way and that all specificities of the case are taken properly into account by the supervisor. This means that two different UT but with the same risk classification are not necessarily treated in the same way, since other factors are taken into account and the supervisory judgement applies. This is considered to be a positive impact on an ongoing basis.

18.84 Impact of less convergence in the consequences of the RAF outcome across Europe may vary according to coverage of the market(s). For example the potential disadvantages may be higher for groups and undertakings operating in multiple countries. This is considered to be a negative impact on an ongoing basis.

On national supervisory authorities:

18.85 Since no automatic rules apply, the supervisor is permitted to exercise supervisory judgement. The supervisor's experience and knowledge are

important components in the process of definition of the work plan for each undertaking. This is considered to be a positive impact on an ongoing basis.

18.86 The risk and impact classifications are an important tool to prioritise the supervisory work on the basis of a preliminary assessment of the undertaking, but the RAF assessment shouldn't imply that every UT in each risk category is treated in the same way. This approach ensures a proper level of flexibility to address various situations with the most appropriate supervisory activities/measures and thereby to address the objectives of risk based and proportionate supervision. This is considered to be a positive impact on an ongoing basis.

18.87 Less automatic rules may promote less convergence among Member States which is more problematic in the case of supervision of cross border groups. This is considered to be a negative impact on an ongoing basis.

18.88 Since supervision under Solvency II is new, the aim is to gain experience and reach harmonization by means of sharing experiences and best practices rather than tying the hands of the supervisors at the outset with strict rules that may not work in practice in all cases. Benefits in the medium term are expected. This is considered to be a positive impact initially and on an ongoing basis.

Option 2

18.89 Description of possible spectrum of detailed review activity or supervisory measures to be taken included in the guidelines or annex.

On policyholders:

18.90 More transparent process, clearer rules, more convergence. This is considered to be a positive impact on an ongoing basis.

18.91 Clear rules can't be defined yet since supervisors need to gain experiences in Solvency II, so just tentative rules could be inserted in guidelines as examples. But those examples may not work in practice. Attempts to define more specific rules could actually potentially endanger protection of policyholders. This is considered to be a negative impact both at initial stages on an ongoing basis.

18.92 Moreover, examples of activities stemming from the different RAF's outcome can't be exhaustive and may be misleading. This is considered to be a negative impact on an ongoing basis.

On industry:

18.93 Predefines rules with regard to activities/measures linked to the different RAF outcomes cannot fit all types of UT. In such case the application of Proportionality over EU could be compromised. This is considered to be a negative impact on an ongoing basis.

18.94 The industry may benefit from more transparency and defined rules even if the rules or examples of activities/measures in the guidelines can't be read as strict rules to be followed. This is considered to be a positive impact on an ongoing basis.

18.95 Inclusion of descriptions of activities stemming from the different RAF's outcome may be misinterpreted by the industry (e.g. the industry may think that supervision is an automatic process) and create situations for potential moral hazard. This is considered to be a negative impact on an ongoing basis.

18.96 The identification of a ladder or an escalation of intervention instead of a general guideline on measures would lead to more consistent and convergence of action but is not always straightforward since several factors need to be taken into account when evaluating of the impact and severity of the measures. This is considered to be a marginally positive impact on an ongoing basis.

18.97 The inclusion of a description of possible activities may lead to more convergent practices more quickly. This aspect is more relevant for undertaking and groups that operate in more than one member state. This is considered to be a positive impact on an ongoing basis.

On national supervisory authorities:

18.98 Inclusion of descriptions of activities could compromise the application of risk-based and proportionate supervision and the exercise of supervisory judgement and flexibility. This is considered to be a negative impact on an ongoing basis.

VI - Comparison of Options

18.99 Options to address the Policy Issue 1 - The level of flexibility within the process as a whole – can be summarised in their effects according to the following table:

Policy Option	Relevant objectives									
	Achieve consistent outcomes through the convergence of supervisory processes and practices within the Supervisory Review Process		Ensure sufficient flexibility for national supervisory authorities to be able to appropriately adapt their actions on a case-by-case basis, taking into account the specificities of the undertakings involve, their own national markets and other supervisory priorities		Harmonise supervisory methods, tools and powers		Introduce proportionate requirements for small undertakings		Ensure efficient supervision of insurance groups and financial conglomerates	
	Effectiveness (0/+/>++)	Efficiency (0/+/>++)	Effectiveness (0/+/>++)	Efficiency (0/+/>++)	Effectiveness (0/+/>++)	Efficiency (0/+/>++)	Effectiveness (0/+/>++)	Efficiency (0/+/>++)	Effectiveness (0/+/>++)	Efficiency (0/+/>++)
Option 1:	++	0	0	0	+	+	0	0	++	0
Option 2:	+	++	++	+	+	++	++	++	+	++

18.100 While each of the two policy options present positive and negative impacts for the parties considered in this impact assessment, the decision as to the most suitable was based on which option presented the most numerous and significant benefits to policyholders, NSAs and UTs and which contributed most significantly to the objectives of supervision and the supervisory review process as per level 1 (and as outlined in section 2

of this paper).

- 18.101 On that basis, policy option 2 was selected as the option that;
- I.** Provides for the greatest opportunity for widespread protection for policyholders, whilst also meaningfully contributing to risk based and proportionate supervision.
 - II.** Whilst contributing to the objective of convergence in supervisory practices and tools by setting a high level process for SRP and thereby providing guidance to NSAs as to how they might meet their objectives under Solvency II and ensuring a level of consistency in approach across the EU, it allows for flexibility and the application of supervisory judgement to best facilitate undertaking, group and market focused supervision.
 - III.** Contributes to effective co-operation and communication between different NSAs, particularly in the case of group supervision.
 - IV.** Allows for a cost effective implementation of a Solvency II SRP requirements by providing the high level principles to be followed by all NSA, enabling NSAs to work together if they so wish in the design and implementation of an operating model for their market, but similarly providing the flexibility within that to make the necessary adaptations to ensure that the most appropriate model is implemented in each market.

18.102 Options to address the Policy Issue 2 - The level of detail included in the guidelines on risk and impact assessments - can be summarised in their effects according to the following table:

Policy Option	Relevant objectives									
	Achieve consistent outcomes through the convergence of supervisory processes and practices within the Supervisory Review Process		Ensure sufficient flexibility for national supervisory authorities to be able to appropriately adapt their actions on a case-by-case basis, taking into account the specificities of the undertakings involve, their own national markets and other supervisory priorities		Harmonise supervisory powers, methods and tools		Introduce proportionate requirements for small undertakings		Ensure efficient supervision of insurance groups and financial conglomerates	
	Effectiveness (0/+/++)	Efficiency (0/+/++)	Effectiveness (0/+/++)	Efficiency (0/+/++)	Effectiveness (0/+/++)	Efficiency (0/+/++)	Effectiveness (0/+/++)	Efficiency (0/+/++)	Effectiveness (0/+/++)	Efficiency (0/+/++)
Option 1	++	+	0	0	++	+	++	+	++	+
Option 2:	+	+	++	+	+	+	++	++	+	+

18.103 For this policy question the decision as to the most suitable of the 2 options was based on which option is likely to result in the highest protection for policyholders and which is more likely to ensure risk based, prospective and proportionate supervision in the EU/EEA as a whole and within individual Member States.

- 18.104 On that basis, policy option 2 was selected as being the most appropriate as it is the option that:
- I.** Within an EU/EEA wide high level standard and consistent approach to impact and risk assessment, provides for undertaking, group and market focused supervision.

- II.** Enables a more risk based and proportionate approach to supervision as well as facilitating adaptation by individual NSAs as appropriate and necessary.
- III.** Recognises that there is a lot of practical experience to be obtained, by both industry and NSAs, in a live Solvency II environment and it provides the flexibility for that learning to occur and for approach to risk and impact assessment to be adapted in light of that, instead of fixing the parameters for such assessment before appropriate experience has been gained.
- IV.** Facilitates, through the existence of a high level consistent approach, information and experience sharing between NSAs in terms of practical experiences of supervision and necessary information exchange within supervisory colleges.

18.105 Options to address the Policy Issue 3 - The level of detail included in the guidelines on supervisory consequences arising from the outcome of the Risk Assessment Framework - can be summarised in their effects according to the following table:

Policy Option	Relevant objectives									
	Achieve consistent outcomes through the convergence of supervisory processes and practices within the Supervisory Review Process		Ensure sufficient flexibility for national supervisory authorities to be able to appropriately adapt their actions on a case-by-case basis, taking into account the specificities of the undertakings involve, their own national markets and other supervisory priorities		Harmonise supervisory powers, methods and tools		Introduce proportionate requirements for small undertakings		Ensure efficient supervision of insurance groups and financial conglomerates	
	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	Effectiveness (0/+ /++)	Efficiency (0/+ /++)
Option 1	+	+	++	++	+	+	++	++	+	+
Option 2:	++	+	0	0	++	+	0	0	+	0

18.106 For Policy Issue 3 the decision, as to the most suitable of the 2 options, was based on which option is likely to result in the highest protection for policyholders and better facilitate risk based, prospective and proportionate supervision in the EU/EEA.

18.107 On that basis, policy Option 1 was selected as being the most appropriate as it is the option that:

- I.** Through an EU standard high level framework for SRP which sets out the elements to be considered in deciding on supervisory actions and measures, provides for the most situational, undertaking, group and market specific supervisory actions and measures.
- II.** As such, promotes the highest level of protection for policyholders
- III.** Enables a more risk based and proportionate approach to supervisory actions and measures and, within this, facilitates the application of supervisory judgement and experience
- IV.** Facilitates, through the existence of a high level consistent SRP, information and experience sharing between NSAs, in terms of practical experiences of supervision and necessary information exchange within supervisory colleges, and sets the scene for further convergence on these once more practical experience has been built up in a live Solvency II environment.

TITLE II – Insurance Groups

Chapter I – Group Solvency

19. Group Solvency Calculation

I - Procedural Issues and Consultation of interested Parties

- 19.1 The content of this impact assessment document was informally considered and developed as the Guideline paper on the group solvency calculation by the Group Solvency Sub-Group (GSSG). GSSG is a sub-group of Insurance Groups Supervision Committee (IGSC).
- 19.2 This impact assessment document presents the key policy questions and the associate policy options considered in developing the Guidelines for Group Solvency Calculation.
- 19.3 To date there has been one informal pre-consultation with selected stakeholders at the beginning of 2012 on the Guidelines and one formal public consultation in the summer 2014. This impact assessment reflects the outcome of the public consultation

Background information

- 19.4 Title III of Solvency II sets out the main principles to be applied when assessing the group solvency calculation.
- 19.5 The Guidelines on Group Solvency Calculation have a twofold goal:
- providing clarity on the group solvency calculation, particularly with regards to the application '*mutatis mutandis*' of the solo solvency calculations at group level;
 - specifying and harmonising the requirements of the calculation of group solvency.
- 19.6 The Guidelines are addressed to authorities competent under Solvency II.
- 19.7 The Guidelines provide guidance on the treatment of EEA groups as well as any subgroup established in the EEA in the context of Articles 215 to 217 of Solvency II.

II - Problem Definition

- 19.8 In the absence of any Guideline on group solvency calculation, insurance and reinsurance groups would need to interpret the Level 1 and Level 2 requirements for the group solvency calculation.

19.9 This could mean that the interpretation of the Solvency II regulatory text may differ, potentially significantly, between different groups and national supervisory authorities.

19.10 As a result, the group solvency calculation assessed under different interpretations may not be comparable for any two insurance or reinsurance groups. This would create uncertainty and possibly undermine both the creation of a level playing field as well as the effective protection of policyholders.

19.11 Another potential impact of no Guidelines is on the group supervision. An inconsistent interpretation of the regulatory text between Member States may prompt groups to try to arbitrage between different national supervisors' interpretation within the EU, putting policyholders at risk.

Power & Rationale

19.12 In addition to the objective of avoiding the problems mentioned above and considering the appropriateness of the power to develop Guidelines on the group solvency calculation, EIOPA has responsibilities arising from its establishing regulations which oblige it to, amongst other things:

- contribute to high quality of common regulatory and supervisory standards, practices and culture;
- ensure consistent efficient and effective application of legally binding Union law, including Solvency II;
- prevent regulatory arbitrage within the Union;
- ensure effective and consistent supervision of financial institutions in the Union.

19.13 These are the main reasons and powers for the development of this Guideline paper.

III - Objectives Pursued

19.14 The objectives pursued in developing the Guidelines on group solvency calculation and the related IA report are consistent with some of the high level objectives set for the overall Solvency II project including:

- ensuring better regulation,
- deepening the integration of the EU insurance market,
- enhancing policyholder protection,
- advancing supervisory convergence and cooperation,
- increasing transparency,
- promoting international convergence.

19.15 Linked to these high level objectives, EIOPA's Guidelines on the group solvency calculation aim at setting out:

- a process for assessing the scope of the group and sub-group supervision;
- a process for consolidating data under the default accounting consolidation-based method in the group solvency calculation; and
- the details on technical areas, including treatment of ring-fenced funds and assessment of available own funds for group solvency purposes.

19.16 All these specific objectives are meant to complement and integrate previous levels of legislation, in order to avoid the problems described in chapter "Problem Definition".

IV - Policy Options

19.17 EIOPA has identified 3 key policy questions which were considered and debated during the development of the Group Solvency Calculation Guidelines:

- The scope of group supervision for third country groups based in a country with equivalent group supervision regime (**Guideline 5**);
- Application of criteria for identifying subsidiaries with limited liability (**Guideline 10**);
- Treatment of the ring-fenced funds (RFF) in the group solvency calculation (**Guideline 15**);

19.18 The remaining Group Solvency Calculation Guidelines provide clarity on the Level 1 and Level 2 without adding any new requirement and any material cost. Therefore they are excluded from this impact assessment, which focuses on Guidelines 5, 10 and 15.

19.19 As for **Issue n. 1**, the policy consideration was the requirement of an EEA sub-group supervision for third country groups in equivalent regimes as assessed under Article 260: whether EEA sub-group supervision of a third country group in equivalent regime should be waived at all times (Option 1), should not be waived (Option 2) or waived on a case-by-case basis (Option 3).

19.20 As for **Issue n. 2**, the policy consideration was when should the criteria for identifying subsidiaries with limited liability be applied: whether the criteria should be applied at all time (Option 1) or only when a subsidiary is in a deficit (Option 2).

19.21 As for **Issue n. 3**, two policy options were considered:

- No intra-group transactions are eliminated between the assets and liabilities associated with RFFs and the remaining consolidated data for the calculation of the notional SCR and the RFF restricted own funds for the group solvency calculation. This implies that for RFF identified in EEA insurance undertakings, group solvency calculation

should use the notional SCR and the RFF restricted own funds that were calculated at an individual level (Option1);

- All intra-group transactions are eliminated between the assets and liabilities associated with RFFs and the remaining consolidated data for the calculation of the notional SCR and the RFF restricted own funds for the group solvency calculation. This implies that for RFF identified in EEA insurance undertakings, group solvency calculation should re-calculate the notional SCR and the restricted own funds within the ring-fenced funds that were calculated at an individual level (Option 2).

V - Analysis of Impact

The scope of group supervision for third country groups based in a country with equivalent group supervision regime (Guideline 5)

19.22 If applied without an appropriate coordination with other related provisions, Recital 99 and Article 215 of Solvency II require group supervision at the ultimate level in the Union for all groups, irrespective of where they are an EEA or a third-country group. However, Article 261 prescribes that "Member States shall rely on the equivalent group supervision exercised by the third-country supervisory authorities".

19.23 Reading Recital 99 and Article 215 together with Article 261 lead to some ambiguity as to what "rely" means in Article 261. In order to achieve maximum harmonization, Guideline5 aims to provide an interpretation that helps address this ambiguity.

19.24 In developing the Guideline the following policy options were considered:

- a. Option 1 – EEA group supervision is not performed for regimes considered equivalent in accordance with Article 260 (giving primacy to Article 261);
- b. Option 2 – EEA sub-group supervision is performed for all third-country groups, irrespective of their equivalence status under Article 260 (giving primacy to Recital 99 and Article 215); and
- c. Option 3 – waiving EEA sub-group supervision for third-country groups on a case-by-case basis (a combined and balanced interpretation).

19.25 On the side of benefits, it is possible to detect the following effects of

Option 1:

- Policyholders - None⁵;
- Industry - Lower operational costs since EEA sub-group supervision is not performed at the ultimate Union level;

⁵ 'None' refers to no material impact through all this assessment

- Group supervisors – Lower operational costs since EEA sub-group supervision is not performed at the ultimate Union level.

19.26 On the side of costs, it is possible to detect the following effects of **Option 1**:

- Policyholders – In the case of waiving all times the EEA sub-group supervision for a third-country group based in equivalent or in a temporary equivalent regime, European policyholders may not get, in some cases, the same level of protection as they would if an EEA sub-group supervision is performed;
- Industry - None;
- Group supervisors – for third countries that are granted temporary equivalence, EEA sub-group would have to rely on group supervision performed by a third country authority that is working towards developing an equivalent group supervision framework. Therefore in the interim there may be limitations to the group solvency calculation performed by the third country authority.

19.27 On the side of benefits, it is possible to detect the following effects of **Option 2**:

- Policyholders – policyholder are offered appropriate level of protection, as envisaged by Solvency II, through the EEA sub-group supervision;
- Industry - None;
- Group supervisors - application of a sub-group supervision all the times without the need to perform a case-by case assessment.

19.28 On the side of costs, it is possible to detect the following effects of **Option 2**:

- Policyholders - None;
- Industry – higher operational costs associated with EEA sub-group supervision at the ultimate Union level;
- Group supervisors – higher operational costs associated with conducting EEA sub-group supervision at the ultimate Union level particularly for third countries where equivalent sub-group supervision will be in place as at 1st of January 2016.

19.29 On the side of benefits, it is possible to detect the following effects of **Option 3**:

- Policyholders – appropriate level of policyholder protection, as envisaged by Solvency II, through the EEA sub-group supervision where needed;
- Industry - Lower operational costs since EEA sub-group supervision is not performed at the ultimate Union level where not needed and not justified according to the criteria listed in the Guideline;
- Group supervisors – the level of supervision is decided on case-by case basis taking into account the specific features of the group.

19.30 On the side of costs, it is possible to detect the following effects of **Option 3**:

- Policyholders - None;

- Industry – higher operational costs associated with EEA sub-group supervision at the ultimate Union level for third countries where deemed needed by the European supervisory authorities;
- Group supervisors – higher operational costs associated with the EEA sub-group supervision at the ultimate Union level and with a case-by-case assessment.

Application of criteria for identifying subsidiaries with limited liability (Guideline 10)

19.31 If groups can demonstrate strictly limited liability to a subsidiary, Article 221(1) of Solvency II allows groups to recognise solvency deficits in that subsidiary on a proportional basis. Otherwise groups are required to recognise a solvency deficit in full for all subsidiaries by default.

19.32 The Guideline develops criteria to ensure a consistent interpretation of Article 221(1) when identifying situations where groups have limited liabilities to subsidiaries.

19.33 The policy question considered was when should the criteria apply: at all times (Option 1) or only when the subsidiary is in a deficit (Option 2).

19.34 On the side of benefits, it is possible to detect the following effects of **Option 1:**

- Policyholders - Policyholders are made aware that the group has limited liability to a local insurer. This allows policyholders to make an informed decision when buying insurance from their local insurer;
- Industry - Groups know in advance which of the subsidiaries have met the criteria for limited liabilities. This allows for better risk management and capital planning;
- Group supervisors - Group supervisors will know in advance which of the subsidiaries have met the criteria for limited liabilities. This allows for improved supervision and resource planning.

19.35 On the side of costs, it is possible to detect the following effects of **Option 1:**

- Policyholders - None;
- Industry - Groups will have to commit resources to assess subsidiaries against the criteria for limited liabilities but those subsidiaries may never go into a deficit;
- Group supervisors - Group supervisors will have to commit resources to review groups assessment of subsidiaries against the criteria for limited liabilities but those subsidiaries may never go into a deficit.

19.36 On the side of benefits, it is possible to detect the following effects of **Option 2:**

- Policyholders - None;
- Industry - Groups will only commit resources to assess a subsidiary against the criteria for limited liabilities when there is a deficit in a subsidiary;
- Group supervisors – Group supervisors will only commit resources to review a group’s assessment of a subsidiary against the criteria for

limited liabilities only when there is a deficit in a subsidiary. There have been very few cases where groups have requested to demonstrate limited liability for a subsidiary in the past. Application of the criteria is expected to be infrequent.

19.37 On the side of costs, it is possible to detect the following effects of **Option 2**:

- Policyholders - Policyholders are only made aware that a group has limited liability when their local insurer is in deficit. Application of the criteria when a subsidiary is in deficit has a limit, because it does not allow policyholders to make an informed decision when buying insurance from their local insurer;
- Industry - Groups will not know in advance if a subsidiary that, in their view, meets the criteria will satisfy supervisory review. This will hinder their risk management and capital planning;
- Group supervisors - Group supervisors will not know in advance if a group intends to assess a subsidiary against the criteria until the subsidiary is in a deficit. This constitutes a limit, because it makes supervision more challenging, with last minute calls on additional resources to assess firms' submissions against the criteria.

19.38 On the side of costs, it is possible to detect the following effects of **Option 1**:

- Policyholders - None;
- Industry - Capital costs associated with restricting any unavailable capital from the group own funds and operational costs associated with performing the availability assessment for ASUs and SPVs;
- Group supervisors - Group own funds are overstated because own funds in an ASU or SPV are considered available at the group without an appropriate availability assessment and operational costs associated with reviewing the availability assessment for ASUs and SPVs.

19.39 On the side of benefits, it is possible to detect the following effects of **Option 2**:

- Policyholders - None;
- Industry - Lower capital costs associated with restricting any unavailable capital from the group own funds and lower operational costs associated with performing the availability assessment for ASUs and SPVs;
- Group supervisors - Lower operational costs of reviewing the availability assessment for ASUs and SPVs.

19.40 On the side of costs, it is possible to detect the following effects of **Option 2**:

- Policyholders - Not assessing own funds restrictions from ancillary services undertakings and special purpose vehicles could result in group over stating the funds available to it to absorb losses elsewhere in the group. This could lead to lower policyholder protection from a group perspective;
- Industry - Groups do not have a clear view on the capital that can be made available to absorb losses anywhere within the group. This can

be seen as a limit to capital management optimisation and to the capacity to plan;

- Group supervisors – Group supervisors are not aware of any capital availability restrictions from SPVs and ancillary services undertakings until the stress conditions occur and the capital has to be transferred around the group. As before, this is a limit for supervisory authorities organise their activity in effective and efficient basis.

Treatment of the ring-fenced funds in the group solvency calculation (Guideline 15)

- 19.41 Certain own fund items in an undertaking may have a reduced capacity to fully absorb losses on a going-concern basis due to their lack of transferability within an undertaking. Assets and liabilities associated with such own fund items are considered ring-fenced funds ('RFFs').
- 19.42 Solvency II and the draft consolidated Implementing Measures set out the details on how to identify and treat RFFs in the solvency calculation for an undertaking ('a solo').
- 19.43 Where accounting consolidation-based method is used, groups will be required to identify all assets and liabilities associated with RFF and treat them accordingly. Eliminating intra-group transactions ('IGTs') between a RFF and the remaining part of the consolidated data will change the underlying assets and liabilities associated with a RFF and thereby the individual calculations for the notional SCR and the RFF restricted own funds can no longer be used at group level.
- 19.44 The two policy options consider whether or not intra-group transactions should be eliminated between RFF and the remaining part of the consolidated data for the purposes of the notional SCR and RFF restricted own funds calculation.
- 19.45 **Option 1** states that no elimination should be done.
- 19.46 **Option 2** that intra-group transactions should be all eliminated.
- 19.47 Implication of **Option 1**: since IGTs are not eliminated this implies that groups can use the same notional SCR and RFF restricted own funds calculated at individual level in the group solvency calculation for all RFF identified in the group's EEA operations.
- 19.48 Implication of **Option 2**: since IGTs are eliminated this implies that groups must re-calculate the notional SCR and RFF restricted own funds for all material RFF based on the assets and liabilities associated with a RFF net of IGTs. This must be done for all material RFF, irrespective of whether they are within the EEA or non-EEA operation.
- 19.49 On the side of benefits, it is possible to detect the following effects of **Option 1**:

- Policyholders - The RFF restricted own funds at the group level are the same as the one calculated at individual level for EEA RFFs. This offers policyholders the same level of protection at the group level as it does at individual level. As far as the protections at individual level is considered sufficient, the same judgement would extend to the group level;
- Industry - Groups do not have to perform additional RFF calculations at group level for their EEA operations;
- Group supervisors – A clear approach to group supervision since the notional SCR and the RFF restricted own funds calculated at the solo level are used in the group solvency calculation. This is a benefit over option 2 where the notional SCR and the RFF restricted own funds are recalculated net of IGTs. This recalculation could result in a higher or lower notional SCR and the RFF restricted own funds calculated at group level compared to the individual level. As a result of eliminating IGTs, group supervisors would be required to consider which of the two calculations offer the appropriate level of policyholder protection at group level, leading to an unclear approach to group supervision of RFFs.

19.50 On the side of costs, it is possible to detect the following effects of **Option 1**:

- Policyholders - None;
- Industry - None;
- Group supervisors - Group supervisors would not be able to immediately distinguish between external and internal risk exposures of the assets and liabilities associated with a RFF since IGTs have not been eliminated. However, all material IGTs are reported separately in the group reporting templates (template G14), therefore Group Supervisors will be able to identify all the material IGTs between the RFF and rest of the group.

19.51 On the side of benefits, it is possible to detect the following effects of **Option 2**:

- Policyholders - None;
- Industry - None;
- Group supervisors - Group supervisors have a clearer view of the actual external risk profile of the assets and liabilities associated with a RFF since all IGTs are eliminated.

19.52 On the side of costs, it is possible to detect the following effects of **Option 2**:

- Policyholders - The restricted RFF own funds calculated at group level may be lower than the restricted RFF own funds calculated at individual level for RFFs in the group's EEA subsidiaries. If the restriction calculated at the group level is used, the RFF policyholders would have reduced protection at group level than at individual level;
- Industry - Groups will have to recalculate the notional SCR and the restricted RFF own funds at group level;
- Group supervisors – Under Option 2 the notional SCR and the RFF restricted own funds are recalculated at group level using assets and liabilities associated with RFF net of IGTs. This could result in the recalculated notional SCR and the RFF restricted own funds at group

level to be larger or smaller than the ones calculated for the same RFF at individual level. If the recalculated notional SCR and RFF restricted own funds at group level are smaller than at individual level, the group solvency calculation effectively offers lower policy holder protection since the own funds restriction for a given RFF in an EEA operation is lower at group level compared to individual level. This may lead to the college deciding to use the higher of the two RFF restricted own fund calculation (solo vs. group) to ensure appropriate policyholder protection. The use of higher of the two RFF restricted own funds could lead to an inconsistent approach to supervision where either the group calculated restriction or the individual calculated restriction is deducted from the group own funds depending on which one is higher.

VI - Comparing the Options

- 19.53 The following section should be read in conjunction with the previous section, "Analysis of Impact". This section sets out the rationale for the options selected for each policy question. This section does not repeat the cost/benefits already discussed at length in the previous section.
- 19.54 Regarding the scope of group supervision for third country groups based in a country with equivalent group supervision, we have opted for **Option 3**, i.e. waiving EEA sub-group supervision for third country groups on a case-by-case basis. This offers policyholders the appropriate level of protection, as envisaged by group supervision in Solvency II, where deemed necessary by the supervisory authorities of the ultimate parent undertaking in the Union European on the base of a defined list of criteria.
- 19.55 Regarding the application of criteria for identifying subsidiaries with limited liability, we have opted for **Option 1**, i.e. the criteria should be applied at all time. This allows: policyholders to make an informed decision when buying insurance from their local insurer; groups to know in advance which of the subsidiaries have met the criteria for limited liabilities; and group supervisors to know in advance which of the subsidiaries have met the criteria for limited liabilities.
- 19.56 Regarding the treatment of ring-fenced funds in the group solvency calculation, we have opted for **Option 1**, i.e. intra-group transactions are not eliminated for the purposes of the SCR calculation and identifying restricted own funds within the ring-fenced funds only. This option offers the policyholders of the ring-fenced funds the same level of protection at group level as it does at individual level without adding unnecessary complexity to the group solvency calculation.
- 19.57 In summary, the policy options chosen aim to strike a balance between pragmatism and policyholder protection while keeping to group solvency calculation from becoming overly burdensome or complex.

TITLE III – Third Country Equivalence

20. Third Country Equivalence

I - Procedural Issues and Consultation of Interested Parties

- 20.1 In order to fulfil EIOPA's obligation to establish consistent, efficient and effective supervisory practices with regard to equivalence assessments of third countries to be undertaken in accordance with articles 227(2) and 260(1) of the Solvency II Directive (2009/138/EC), EIOPA has developed Guidelines on 'The methodology for Equivalence assessments of national supervisory authorities under Solvency II',
- 20.2 According to Article 16 (2) of the EIOPA Regulation, the Authority shall analyse the potential related costs and benefits of its guidelines. Such analyses shall be proportionate in relation to the scope, nature and impact of the guidelines or recommendations.
- 20.3 The impact assessment (IA) aims to provide the reader with an overview of findings with regard to the problem definition, options identified to remove the problem and their potential impacts.
- 20.4 A public consultation of the Guidelines and its impact assessment was carried out between 2 June 2014 and 29 of August 2014. Stakeholders' comments were duly taken into account and served as a valuable input in order to revise the Guidelines.

II - Problem Definition

- 20.5 The Solvency II recognises the fact that the insurance industry is a global industry. In order to reduce regulatory complexity on undertakings and groups, it allows the European Commission to decide about the equivalence of a third country's solvency and prudential regime (Articles 227 and 260). Where a third country is deemed equivalent by way of a Commission decision it has the following practical effects:
- Article 227 Equivalence: internationally active EU insurance groups which use the Deduction and Aggregation method for calculation of group SCR can use the local rules relating to capital (own funds) and capital requirements rather than the Solvency II rules.
 - Article 260 Equivalence: EU supervisory authorities are required to rely on the group supervision exercised by the third country.

- 20.6 The Solvency II also anticipates that in circumstances where the Commission has not taken a decision on the equivalence of a particular third country, then under Article 227 the group supervisor shall carry out any verification of the equivalence of the third country regime for the purpose of the group solvency calculation, on its own initiative or at the request of the participating undertaking.
- 20.7 Similarly, under Article 260, where there is no Commission decision on equivalence, the verification of whether a particular third country exercises equivalent group supervision to that provided for under Solvency II shall be carried out by the EU supervisory authority which would be the group supervisor if the criteria set out in Article 247(2) were to apply. The verification shall be undertaken at the request of the third country parent undertaking or of any of the insurance and reinsurance undertakings authorised in the Community or on the (EU) group supervisors' own initiative.
- 20.8 EIOPA through its Equivalence Committee has acquired extensive experience in the area of SII equivalence assessments through its multiple submissions to the European Commission regarding third country equivalence (2011 Equivalence Assessments of Switzerland, Bermuda and Japan as well as during 2012/2013 Gap analysis work).
- 20.9 In order to ensure that group supervisors or acting group supervisors follow a consistent approach based on the Equivalence criteria set in Implementing Measures, the methodology proposed through the current Guidelines aims to stand as a blueprint for assessments undertaken at national level. The process established in the methodology is built on the practical experience gained by EIOPA and aims to mitigate any residual risk that different group supervisors or acting group supervisors come to different decisions on the same third country regime through divergent assessment approaches.
- 20.10 The analysis of the expected impact of the Guidelines is compared to the expected impact from a baseline scenario. The baseline is defined as the world under a set of assumptions about what would happen to the equivalence assessments undertaken by group supervisors in the absence of EIOPA's Guidelines establishing a methodology for this work. Given that group supervisors have never pursued any equivalence related work in the area of insurance supervision (except for some limited exceptions for professional secrecy area), these Guidelines change the baseline scenario i.e. the situation of "no methodology" at European level for equivalence assessments undertaken by the group supervisor.

III - Objectives Pursued

- 20.11 In order to mitigate the problem recognised in "Problem definition" of the IA and to clarify the process to be pursued by a group supervisor when undertaking an equivalence assessment, the following objectives have been identified:

- to ensure a convergent and consistent approach to equivalence assessments. Providing a process for group supervisors or acting group supervisors to apply when undertakings request equivalence assessments in accordance with articles 227(2) and 260(1) for the Solvency II Directive so as to avoid inconsistencies in the process and outcome of equivalence assessments undertaken by group supervisors or acting group supervisors.
- to avoid creation of an uneven playing field among insurance undertakings/groups operating in EU and reduce all associated risks for the competent authorities and policyholders.

IV - Policy Options

20.12 The policy issue at stake is whether a set of Guidelines is beneficial or not to address the problem(s) highlighted in "Problem Definition".

20.13 The baseline is the current status quo without EIOPA intervention, meaning, in this case, the complete absence of any EU wide process outline for the purpose of equivalence assessments undertaken by group supervisors or acting group supervisors.

20.14 A formal and complete definition of the baseline is the one offered in the Introduction.

20.15 Against this baseline, the alternative solution is to establish a set of Guidelines providing a process for group supervisors to apply when undertaking equivalence assessments in accordance with articles 227(2) and 260(1) Solvency II.

V - Analysis of Impact

20.16 A cost and administrative burden is expected to fall on competent authorities (CAs) who will be undertaking the equivalence assessments. In relation to article 227 assessments costs may fall more heavily on supervisors that are responsible for groups with subsidiaries in many third countries.

20.17 A cost for EIOPA is also expected with regard to its (facilitation) role. It is expected there will also be a small cost for EIOPA in relation to achieving an overview of the equivalence assessments undertaken at national level and reporting publicly as to their outcome.

20.18 CAs may also encounter additional operational costs as to employees with high technical expertise brought in to cover areas relevant for the equivalence assessment/third party providers which may be also involved in the actual assessment work (which may be separate from those organising and coordinating the equivalence assessment).

20.19 Several competent authorities levy general fees on industry, and some may impose specific contributions on the insurers to cover the costs of

activities undertaken upon their request. Therefore, increased costs arising from an increased administrative burden could be passed on to insurers which in turn, may pass them on to their policyholders (in the form of increased costs). However, based on the experience of CAs and that the overall costs for CAs are estimated to be low, the cost impact on stakeholder groups is not likely to be extensive.

- 20.20 The benefits of having a single EU methodology for equivalence assessments to be undertaken by group supervisors are multiple but we highlight that consistent process facilitates consistent outcomes i.e. consistent equivalence decisions taken on the basis of a full technical analysis. In turn this leads to a fair and level playing field for the EU insurance market, avoidance of regulatory arbitrage and reduction of the potential for unfair competition.
- 20.21 The envisaged EIOPA intervention would have the benefit of providing a single methodology for group supervisors to follow when pursuing an equivalence assessment. While the CAs will retain full powers to take the decision as to the equivalence of a third country in relation to articles 227 or 260 of the Solvency II, having a sound process for undertaking the assessment maximises the chances of having consistent technical outcomes of the analysis of the third country supervisory regime.
- 20.22 Due to the complete absence of prior experience of undertaking SII equivalence assessments, by using the EIOPA methodology the group supervisors would avoid the administrative burden associated with the creation of an internal procedural framework for practical pursuit of the work, and "multiple non-convergent practices" for pursuit of the same body of work would also be averted.
- 20.23 Under the envisaged EIOPA intervention there would be an additional cost and administrative burden which will be created by having EIOPA in a facilitator position as opposed to merely assisting under the terms of the Solvency II Directive. The costs brought about by inconsistency in case of no EIOPA intervention would be much higher (including an uneven playing field for industry; the cost of binding mediation at EIOPA level; reputational risk and subsequent costs for re-establishment of reputation).
- 20.24 Should a third country refuse to participate in an equivalence assessment in relation to Article 227, there may also be costs for undertakings requesting the assessment as they would be invited to provide the information needed for the assessment. Nevertheless, as under the proposed solution there is a clear expectation established as to when, what and how much can be required from the undertaking that requested the assessment, we expect that the impact will be limited in terms of costs. Furthermore, where there is a positive equivalence assessment it is anticipated any cost will be more than offset by the benefits that the insurer may derive from it.
- 20.25 In EIOPA's view a common process for equivalence assessments to be undertaken by group supervisors is a pre-requisite for common outcomes and consistent equivalence decisions at member state level.

The detailed breakdown of effects can be traced as follows:

20.26 Positive impacts of issuing Guidelines

- Member States – a level playing field for insurance undertakings operating in the EU insurance market;
- Competent authorities – consistency and comparability of actions pursued in the context of an equivalence assessment; increase of consistency and convergence of supervisory practices at EU; avoidance of reputational risks linked to / derived from inadequate assessment processes;
- Insurance undertakings requesting the assessment, policyholders – consistent equivalence outcomes contributing to a level playing field at EU level by removing national specific practices in undertaking the equivalence assessment work.

20.27 Negative impacts of issuing Guidelines

- Member States – none;
- Competent authorities - cost of engaging EIOPA as a facilitator (cost expected to be insignificant compared to those under baselines assumption, as this requires just email circulation of information identified by the Guidelines);
- Insurance undertakings - none except for potentially longer timeline for a CA to conclude as to the equivalence of a third country.
- Policyholders - none.

Policy Option	Party Affected	Impact				
		Description	Type of Impact (Direct/Indirect)	Effect (-/?/+)	Likelihood of Impact (L/M/H)	Timing of Impact (S/L/P)
To issue EIOPA Guidelines setting out the methodology to be followed for equivalence assessments undertaken by the group supervisor.	Policyholders (PH)	Indirectly affected i.e. only if CAs pass on the costs to insurance undertakings and/or create a massive administrative burden at the level of the undertaking that would then be reflected in costs for the PH	Indirect	?	L	L
	Insurance undertakings	Potentially reduced costs arising from CA passing on costs associated with the assessment to the undertaking	Indirect	?	M	L
		Reduces probability of CAs creating an uneven playing field as to the approach to the equivalence assessment	Direct	+	H	P
	Competent authorities	The CAs will have a ready available process for them to use during equivalence assessments.	Direct	+	H	P
	EIOPA	There will be a minimisation of risk regarding divergent CA assessment processes	Direct	+	H	P

Policy Option	Relevant objectives				Additional quality indicators	
	to ensure convergent and consistent supervisory practices for the purpose of equivalence assessments		to avoid creation of an uneven playing field among insurance undertakings/groups operating in the EU & reduce all associated risks for the CAs and PHs		sustainability	consistency
	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	Effectiveness (0/+ /++)	Efficiency (0/+ /++)	(0/+ /++)	(0/+ /++)
Issuing Guidelines	++	++	++	++	++	

Analysis of Impact of Sub-Options

20.28 As previously stated, articles 227 (2) and 260 (1) of the Solvency II directive clearly establish the CA's/group supervisor's ability and power to decide as to equivalence of a third country supervisory regime. These decisions would be based on a technical analysis i.e. equivalence assessment using the criteria to be established by the Implementing Measures. The legal text is silent with regard to how to organise the technical work of assessing third country equivalence.

20.29 For the organisation of the work of pursuing these equivalence assessments, two sub-options have been identified:

- **Sub-option A** – competent authorities pursue the equivalence assessments at national level using the methodology provided through EIOPA Guidelines. EIOPA will always be notified of the work being undertaken at national level and will ensure all interested parties are informed of progress;
- **Sub-option B** – one or more competent authorities that have been asked to undertake equivalence assessments of third country supervisory regimes may request the EIOPA Board of Supervisors to mandate EIOPA Equivalence working structures to undertake the technical work.

Positive impacts of sub-option A can be summarised as follows:

- 20.30 Higher level of supervisory consistency when undertaking equivalence assessments compared to the baseline assumption [i.e. no Guidelines at all].
- 20.31 Both assessment and decision are undertaken by the same CA and this may result in a higher ability to explain to the group the CA decision on equivalence. This CA would also have the highest familiarity with the insurance group requesting the assessment.

Negative impacts of sub-option A are as follows:

- 20.32 Increased costs for CAs / group supervisors which when adding total costs of all assessments done for the same third country could prove higher than the cost of EIOPA undertaking the work.

Positive impacts of sub-option B can be summarised as follows:

- 20.33 The work would be undertaken by an experienced body of EIOPA and national experts. The EIOPA working structures have already been undertaking SII equivalence assessments for 3 years now;
- 20.34 The outcome of the work done by EIOPA would be submitted to the EIOPA BoS members for review and subsequent use in national decision making processes as to third country supervisory equivalence;
- 20.35 While ultimately the equivalence decision is the responsibility of the group supervisor, the process minimises to the point of exclusion any risks related to creation of an uneven playing field / reputational risk to CAs that could arise from differences in practice that may occur when undertaking the assessment at national level;
- 20.36 The work would become an EIOPA deliverable and as such would require adequate allocation of resources to it. Nevertheless, the costs incurred at EIOPA level would most likely be lower when compared to added costs for the same third country being assessed by multiple EU supervisors.

Negative impacts of sub-option B are as follows:

20.37 Use of option B is a fully discretionary decision for the CAs that have the ability to request it but also for the EIOPA BoS which may or may not approve such a request. This is also expected to lead to an increase, depending on the number of request even significant increase, in allocated resources from EIOPA-side for this work.

Conclusion:

20.38 Taken into account the above, if assessments for the same third country are requested to multiple EU supervisors, sub-option B might be the favourable option. But given that use of sub-option B is fully discretionary (both for CAs which may or may not request it but also for the EIOPA BoS which may or may not approve such a request), it is concluded that the Guidelines shall provide for both options A and B.

VI - Comparing the Options

20.39 The comparison of options shows that the set of Guidelines proposed by EIOPA is expected to produce overall significant benefits such as clarity on process to be followed, consistent and convergent supervisory practice, equal and fair treatment of third countries and undertakings during the assessment, fostering a level playing field for EU insurance groups (case of Article 227) and third country groups operating in Europe (case of Article 260). These will exceed costs created by its implementation 2 (linked to information sharing).

20.40 After careful review of the expected impacts, the major parties affected in a direct way are the competent authorities and insurance groups. There may be some very minor indirect costs on insurance undertakings and their policyholders due to process in Member States. Nevertheless, the expected benefits arising from consistent outcomes on equivalence are anticipated to significantly out-weight these costs.

20.41 There will be also a cost to be incurred by EIOPA as it will need to facilitate the process by way of information sharing among CAs which may depend on the number of countries assessed and respective complexity of their supervisory systems.

20.42 Given that use of sub-option B is fully discretionary (both for CAs which may or may not request it but also for the EIOPA BoS which may or may not approve such a request), it is concluded that the Guidelines shall provide for both options A and B.

Monitoring and Evaluation

20.43 The evaluation will test if the methodology for equivalence assessments proposed in EIOPA guidelines is effective and efficient against the objectives specified in point 3 of the impact assessment. This could be done by e.g., monitoring of outcomes whether the technical assessment is

undertaken by the CA or EIOPA, monitoring of related supervisory work in the context of colleges, drafting reports etc.

20.44 Monitoring could include reporting on failures on e.g. providing information within deadlines, providing/sharing relevant information as identified in the guidelines, use of template questionnaire, number of binding mediation procedures to be triggered by inconsistent CA decision on equivalence or lack of thereof in respect of the same third country etc.

Objective	Indicators
to ensure convergent and consistent supervisory practices for the purpose of equivalence assessments	The number of competent authorities that comply with the guideline.
to avoid creation of un-even playing field among insurance undertakings/groups operating in EU & reduce all associated risks for the CA's and PHs	Number of authorities that comply with the procedures consistently. Number of assessments where authorities reach consistent results. Reduced burden on insurance undertakings requesting the assessment to be undertaken (especially for art. 227 when third country is not cooperating).