



EIOPA-CP-14/020
2 June 2014

Cover note for the Consultation
On
Guidelines for Solvency II (set 1)

1. Introduction

- 1.1. EIOPA invites comments from stakeholders on the first set of Guidelines and their Impact Assessment for Solvency II.
- 1.2. Comments are due by 29 August 2014, using the template provided on EIOPA's website.
- 1.3. EIOPA has developed the Guidelines based on Directive 2009/138/EC (hereafter "Solvency II"), as amended by the Omnibus II Directive, and the current Commission's Delegated Acts (non-public, dated March) containing the draft implementing measures (hereafter "implementing measures").
- 1.4. Following the period of public consultation, EIOPA will consider whether modifications to the Guidelines are additionally necessary as a result of the latest text of the implementing measures.¹
- 1.5. For the purpose of the consultation, where reference is being made to draft articles of the implementing measures, an annex accompanies the consultation listing the relevant articles. This annex is not subject to the consultation.

2. Nature of guidelines

- 2.1. Guidelines (GL) are non-binding instruments drafted by EIOPA addressed to National Competent Authorities (NCAs) or Financial Institutions, with the aim of ensuring the common, uniform and consistent application of Union law as well as with a view to establishing consistent, efficient and effective supervisory practices in accordance with Article 16 of the Regulation establishing EIOPA.² They shall be in line with the empowering regulation and implementing measures which the Guidelines are aiming to clarify.
- 2.2. The NCAs shall make every effort to comply: within a period of two months following the issuance of the Guidelines, they shall report to EIOPA whether they comply, intend to comply or do not comply with the GL. When reporting non-compliance, the NCA shall state the reasons for this non-compliance. EIOPA publishes the replies; the reasons for non-compliance are only published on a case-by-case basis.
- 2.3. EIOPA has the obligation to list in its Annual Report the NCAs that reported non-compliance as well as the measures to be taken. A report on the

¹ It is anticipated that the Commission will publish the implementing measures later this year. The implementing measures will then be subject to a period of scrutiny by the European Council and Parliament.

² Regulation (EU) no 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority).

compliance will be sent to the European Commission, Parliament and Council.

- 2.4. As for any policy development tool EIOPA conducts a public consultation, performs a cost and benefit analysis (Impact Assessment) and consults the relevant Stakeholder Group for their opinion.
- 2.5. Following the public consultation EIOPA intends to adopt the final Guidelines, which would then be translated and published on its website.

3. Structure of the Consultation Papers

- 3.1. For the ease of consultation, the Guidelines are being consulted in five Consultation Papers that have been compiled according to topics reflecting the relation between the topics, as well as the structure of the Solvency II Directive and the (non-publicly available) implementing measures. The following papers are being consulted on:
 - 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; and
 - Consultation Paper on Equivalence GL.
- 3.2. A separate Consultation Paper contains the Impact Assessment (IA) for the Guidelines. Presenting the IA in one global consultation paper allows stakeholders to assess the links between some issues and to understand the common basis of the IA, in particular the choice of the baseline. Comments on this paper are also being collected in the single comment template, where comments can be made per topic (Pillar 1, Internal Models, ORSA, Governance, SPR and Equivalence) on the Guidelines as well as the Impact Assessment.
- 3.3. Whilst the papers are grouped in five major Consultation Papers, some topics cut across different papers. For example, the CP on Internal Models contains a section on assumptions and expert judgment, based on Article 4 of the draft implementing measures. These apply in a consistent manner for all undertakings, and not only internal models users. This means these Guidelines should be read together with the Guidelines on the system of governance on the valuation of assets and liabilities other than technical provisions (in particular Guidelines 37 and 63 to 71), as well as the Guidelines on the valuation of technical provisions.

4. Key features of the Guidelines in the Consultation Papers

The Pillar 1 Consultation Paper covers the following areas:

GL on ancillary own funds

4.1. The draft Implementing Technical Standard (ITS) (under consultation till end June), sets out the procedure for the supervisory approval of a specified amount of ancillary own funds or a method to determine an amount of ancillary funds. The Guidelines set out a number of important aspects which are not part of the ITS, principally the classification of ancillary own funds and the ongoing satisfaction of the criteria for approval. The Guidelines set out how to classify the three main types of own funds that ancillary own fund items convert into upon being called up; this includes capital instruments, contributions and arrangements which meet an undertaking's liabilities by indemnifying third parties. They also clarify that where an ancillary own-fund item, upon being called up, would take the form of an item which is not included in the defined lists of own fund items in the draft implementing measures, the undertaking would need to separately apply for supervisory approval of the classification of that item.

GL on classification of own funds

4.2. The Guidelines intend to provide for a convergent application of the features for determining the classification of own-fund items set out in the draft implementing measures. This includes for example how to interpret the terms or concepts of: features which may cause insolvency, full flexibility over distributions, principal loss absorbency mechanisms, incentives to redeem and freedom from encumbrances. The Guidelines cover all three tiers that own funds can be classified in.

4.3. Furthermore, the Guidelines set out the approval process for the classification of items that are not included in the defined lists of own fund items in the draft implementing measures; this includes for example items which are not ordinary share capital or preference shares. The approach taken is to replicate the approach for the approval of ancillary own funds, which is dealt with in the draft ITS; for example there are requirements for a cover letter, for approval by Administrative, Management, or Supervisory Body (AMSB), and for a 3-month time period for a decision by the supervisory authority unless there are exceptional circumstances (in which case the time period would be a maximum of 6 months).

4.4. The Guidelines also set out the approval process for the repayment or redemption of a basic own-fund item, setting out the evidence needed from the undertaking, and a requirement for submission of the request 3

months prior to the repayment or redemption date (or contractual notice date to the holder of the item).

GL on ring-fenced funds

- 4.5. The Guidelines concern the identification of ring-fenced funds, the determination of the assets and liabilities within a ring-fenced fund, and how the existence of ring-fenced funds affects the calculation of the SCR both for undertakings applying the standard formula and those using an internal model. The Guidelines are deemed necessary to improve the convergent application of the relatively general definition of a ring-fenced fund in the Solvency II Directive and draft implementing measures and the complex calculations that result from their existence.
- 4.6. Given the different national, legal and product frameworks in Member States, it was decided that it is difficult to provide definitive criteria or a fixed list of arrangements that constitute ring-fenced funds. The Guidelines therefore provide a basis to assess whether a particular arrangement constitutes a ring-fenced fund by setting out characteristics of ring-fenced funds and a list of particular arrangements that are (for example types of with-profits and retirement business in relation to Article 304 of the Solvency II Directive) and are not (for example unit-linked and reinsurance business) generally considered to constitute ring-fenced funds.
- 4.7. Pursuant to Article 70 of the draft implementing measures which sets out a different treatment where a ring-fenced fund is not material, the Guidelines also provide a list of criteria to assess whether a ring-fenced fund is material for example the nature of the risks, and the proportion of assets and capital requirements represented by the fund.

GL on treatment of related undertakings including participations

- 4.8. The Guidelines cover the identification of different types of related undertakings including strategic participations, the treatment of all related undertakings in the SCR calculation (both for the standard formula and internal model users) and how own funds should be determined in the case of participations in financial and credit institutions.
- 4.9. In terms of the identification of related undertakings, the Guidelines provide a list of elements to be used to determine whether an undertaking exerts a dominant or significant influence over another undertaking; for example if there are material transactions between the undertakings, and the involvement of the undertaking in the policy making processes of the other undertaking. Another important element of the Guidelines is the identification of strategic participations, which are subject to a different

treatment within the SCR calculation. The Guidelines set out a list of criteria for this assessment, including how the undertaking should demonstrate that the value of the equity investment is likely to be less volatile, that there is a durable link, and that the holding is consistent with the undertaking's strategy.

- 4.10. The Guidelines are accompanied by detailed Explanatory Text with numerous examples on related undertakings and their treatment. The material also contains a flow chart summarising the calculation approach that should be followed for different holdings in related undertakings.

GL on the standard formula - look-through approach

- 4.11. According to Article 144 of the draft implementing measures undertakings have to apply the look-through approach to collective investment undertakings, other investments packaged as funds, other indirect exposures to market risk, indirect exposures to underwriting risk and indirect exposures to counterparty risk. The Guidelines identify a number of situations when the look-through approach has to be applied and explain how the calculations should be performed in the case of indirect exposures to underwriting risk such as CAT bonds. Further guidance is provided for cases of indirect exposures within indirect exposures (e.g. funds investing in other funds).

GL on the standard formula - basis risk

- 4.12. Undertakings can only include the effect of risk-mitigation techniques when calculating the Solvency Capital Requirement if these techniques do not result in material basis risk unless this risk is reflected in the calculation of the SCR. The Guidelines help undertakings to assess whether a risk-mitigation technique has material basis risk by providing a number of criteria.

GL on the standard formula - market risk

- 4.13. The capital requirement for market risk is one of the main components in the calculation of the Solvency Capital Requirement. The Guidelines provide guidance on the application of the market and counterparty default risk modules. For instance, guidance is provided on the treatment of short equity positions, securities lending agreements, hybrids and employee benefit liabilities as well as on the calculation of the duration in certain situations.

GL on the standard formula - loss absorbing capacity of technical provisions and deferred taxes

- 4.14. The calculation of the Solvency Capital Requirement reflects the fact that part of the losses an insurer may suffer in an adverse scenario are

mitigated by lowering discretionary benefits to be paid to policyholders, and shared with governments in the form of lower taxes to be paid.

- 4.15. The Guidelines provide guidance on the necessary details for the calculation of the adjustment for Loss Absorbing Capacity of Technical Provisions and Deferred taxes for solo undertakings and groups. For instance, guidance is provided in the level of granularity and conditions for the recognition of notional deferred taxes and on the allowed assumptions about future management actions for discretionary benefits.

GL on the standard formula - health CAT

- 4.16. In the similar-to-life techniques (SLT) health underwriting risk module, undertakings have to account for mass accident, accident concentration and pandemic risk.

- 4.17. The Guidelines provide guidance on how to calculate certain quantities necessary to compute the capital requirement for health catastrophe risk. They also provide clarification on the data to be used.

GL on the standard formula - application of the life underwriting risk module

- 4.18. The Guidelines provide guidance on how to calculate the stresses to mortality, longevity, disability-morbidity inception and disability-morbidity recovery rates in the life underwriting risk module. They also clarify how contracts which provide for benefits in different states of disability should be treated.

GL on the standard formula – undertaking specific parameters

- 4.19. Undertakings may use undertaking specific parameters in the calculation of certain sub-modules of the standard formula. The approval process for USP is covered in the ITS. The Guidelines provide guidance on data quality, adjustments to data, the use of external data and the role of expert judgement.

GL on the standard formula - application of outwards reinsurance arrangements to the non-life underwriting risk sub-module

- 4.20. These Guidelines are intended to ensure a common, uniform and consistent application of the undertaking's outwards reinsurance arrangements in relation to the non-life catastrophe risk sub-module.
- 4.21. The Guidelines provide five steps which undertakings should apply sequentially to assess their outwards reinsurance in respect of catastrophe risk: (i) specification of events, (ii) disaggregation of loss, (iii) application of outwards reinsurance, (iv) re-aggregation of net losses and (v) documentation and validation.

4.22. The Guidelines set out how the undertaking should treat outwards reinsurance arrangements which may exist with other group undertakings; i.e. how “internal reinsurance” should be used and how reinsurance should be applied at the level of ultimate parent of a group.

GL on the standard formula - application of the man-made liability catastrophe risk sub-module

4.23. The Guidelines have been drafted to determine the number of liability risks n_i with the largest limits in each of the liability risk groups as defined in the man-made liability catastrophe risk sub-module. The liability risk groups are subsets of risks of the general liability line of business as defined in the draft implementing measures in [Annex NLUR10].

GL on the standard formula - allocation of insurance policies to liability risk groups for the man-made catastrophe risk sub-module

4.24. The Guidelines set out how liability policies should be allocated to the 5 risk liability groups. A particular Guideline is intended for liability insurance sold on a packaged basis, including covers that fall into more than one of the liability risk groups. In such cases, undertakings should unbundle and allocate the premiums for each cover to the most appropriate risk group for that cover.

GLs on group solvency calculation

4.25. The Guidelines on group solvency calculation are aimed at providing clarity and specifying the requirements of group solvency calculation, particularly with regard to the scope of group supervision in the context of third-countries, and the application of the ‘*mutatis mutandis*’ approach, where solo solvency calculation applies at group level. The proposal aims at achieving an appropriate treatment of equivalent third-country jurisdictions in light of the requirements of the Directive with the aim to ensure effective group supervision and supervisory cooperation. The Guidelines also aim at specifying and harmonising the requirements of the calculation of group solvency when applying the accounting consolidation-based method, the deduction and aggregation method and the combination of methods.

4.26. These Guidelines particularly focus on: the assessment of the availability of Own Funds at group level and the treatment of minority interests; the treatment of ring-fenced funds and the treatment of the insurance holding companies and mixed financial holding companies for the purpose of group solvency calculation. In addition, these Guidelines set criteria for identifying subsidiaries with limited liability and specify their treatment.

4.27. The Guidelines are mainly addressed to the participating insurance or reinsurance undertaking, the insurance holding company or the mixed

financial holding company responsible for calculating the group solvency calculation.

GL on the valuation of technical provisions

- 4.28. The Guidelines on the valuation of technical provisions are intended to ensure a harmonised and appropriate interpretation of the implementing measures and to increase consistency and convergence of professional practice for all types and sizes of undertakings across Member States in calculating their technical provisions.
- 4.29. The Guidelines cover Data Quality, Segmentation, Assumptions Setting, Choice of Methods and Validation.
- 4.30. The data quality Guidelines explore how data quality issues should be taken into account and ensure that deficiencies have been appropriately dealt with. The segmentation and unbundling Guidelines explore the ways how to segment the insurance and reinsurance obligations accurately. The assumptions Guidelines recognise that expert judgment is a key component of the calculation of technical provisions and should be applied in setting assumptions to be used in the valuation of technical provisions for insurance and reinsurance undertakings. The Guidelines on methodologies set out requirements on the choice of methodologies to calculate technical provisions and provide a non-exhaustive list of possible approaches for simplifications as part of the general proportionality assessment process. The validation Guidelines focus on the types and selection of validation approaches and processes, timing, extent and documentation and on the assessment of controls which should be carried out by the undertakings to validate the technical provisions.
- 4.31. These Guidelines should ultimately be applied both by actuaries and by others who may be appointed to carry out the tasks of the actuarial function, e.g. coordinating and validating TP valuation.

GL on contract boundaries

- 4.32. The contract boundary Guidelines aim to promote a consistent application of the definition of an insurance or reinsurance contract boundary provided by the draft implementing measures, which define the boundary between existing and future business. The contract boundary determines which insurance or reinsurance obligations arise in relation to a contract based on the nature of the future premiums to be received under the contract.

The Internal Models Consultation Paper covers the following areas:

- 4.33. Complementing the draft ITS on the approval process for internal models (under consultation till end June), the Guidelines on the Use of Internal Models provide guidance on what national competent authorities and

insurance or reinsurance undertakings should consider in order to be able to approve the use of an internal model for the calculation of the Solvency Capital requirement. They further set out what insurance and reinsurance undertakings should consider for being able to use an internal model for the calculation of their Solvency Capital Requirement in compliance with the Directive requirements as further specified in the draft implementing measures.

4.34. The Guidelines cover the following topics:

- Application: elements that undertakings need to consider when submitting an application for the use of internal models, focusing on specificities for internal models for groups.
- Model changes: Guidelines to ensure the appropriateness of the model changes and the policy for changing the internal model developed by the undertaking.
- Tests and standards for internal models approval: Guidelines to help undertakings to comply with the internal models tests and standards and NSAs to assess this compliance, including:
 - Use test
 - Assumption setting and expert judgment,
 - Methodological consistency
 - Probability distribution forecast
 - Calibration
 - Profit and loss attribution
 - Validation
 - Documentation,
 - External models and data.
- Colleges: provisions that colleges should consider when assessing internal models developed by groups.

The Pillar 2 Consultation Paper, including governance and ORSA, covers the following areas:

System of governance

4.35. The Guidelines aim at setting out the requirements for the sound and prudent management of undertakings without unduly restricting undertakings in choosing how to organise themselves, safeguarding

the segregation of duties and operational independence where needed, in particular with respect to key functions, in an appropriate and proportionate approach.

- 4.36. The system of governance is about people, their functions and qualifications, the organisational structure and processes. The requirements on the system of governance entail fit and proper requirements on main actors (key functions, persons who effectively run the undertakings and AMSB).
- 4.37. Guidance is provided on the regular review of the system and the proper documentation.
- 4.38. With respect to the internal audit function, further Guidelines may be needed where developments in the implementing measures would require this.
- 4.39. EIOPA is currently analysing whether further measures can usefully be proposed to enhance the harmonisation of the risk management of LTG measures, in particular in light of Article 44(2a) of OMDII, which requires the assessment of the sensitivity of technical provisions to the assumptions underlying the calculation of the MA, VA and the extrapolation. No Guidelines are currently being issued in this area.
- 4.40. The Guidelines apply to both individual insurance undertakings and *mutatis mutandis* at the level of the group. Additionally, for groups, some group specific Guidelines apply.

ORSA

- 4.41. The requirements for the Own Risk and Solvency Assessment (ORSA) are aimed at providing for a sound and prudent risk management of undertakings through a better understanding of the undertaking's overall solvency needs and capital allocation as well as the interrelation between risk and capital management in a forward looking perspective. It also entails an assessment of the undertaking's risk profile against the assumptions underlying the calculation of its regulatory capital requirements with a view to checking whether the risk profile is adequately covered by the SCR. As a consequence, ORSA provides an additional perspective on solvency assessment.
- 4.42. A further fundamental aspect of the ORSA is that it enhances the involvement and responsibility of the company's administrative, management and supervisory board (AMSB) on those assessments and on the decisions made in terms of risk management. The Guidelines apply *mutatis mutandis* to group level. The presented requirements should guarantee that sufficient and clear information on a company's risk profile

and capital position is provided to supervisors, through a dedicated report.

The SRP Consultation Paper covers the following areas:

- 4.43. The objective of the SRP Guidelines is to achieve consistent outcomes through the convergence of supervisory processes and practices within the Supervisory Review Process, whilst ensuring 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 insurance and reinsurance undertakings and groups involved, their own markets and other supervisory priorities.
- 4.44. The Guidelines focus in a first part on the general principles to be applied by supervisors when performing the Supervisory Review Process (consistency, proportionality, etc.) and in a second part describes the several steps of the process.

The Equivalence Consultation Paper covers the following areas:

- 4.45. The Guidelines aim to ensure that group supervisors follow a consistent approach based on the equivalence criteria set in the draft implementing measures. This process will help to mitigate any residual risk that different group supervisors come to different decisions on the same third country regime through divergent assessment approaches.
- 4.46. In the absence of a decision from the European Commission on the equivalence the regulatory regime of a particular third country, the verification of whether the third country regime is at least equivalent under article 227 (group solvency) and/or article 260 (group supervision) of Solvency II shall be carried out by the group supervisor at the request of the undertaking or at its own initiative. EIOPA shall assist the group supervisor in the assessments. The other supervisory authorities concerned shall be consulted before a decision is taken on equivalence by the group supervisor.
- 4.47. The Annexes to the Guidelines provide a detailed description of the process national supervisory authorities should follow when carrying out the assessment at national level. The Annexes also include a questionnaire, which should be used for collecting the information needed from the third country/undertaking concerned.

5. Proportionality and convergence

- 5.1. EIOPA has chosen to issue Guidelines in the areas set out above as they are considered to be essential for the convergent implementation of

Solvency II from the first day of its application. Nevertheless taking into account the need to be proportionate in the level of detail of the Guidelines, consideration was given to the level of convergence these may achieve. In this respect, two main observations can be made:

5.2. Different levels of convergence can be expected in the different areas. These differences can mainly be attributed to the purpose and subject matter of the Guidelines.

- For example, with regard to internal models, the Guidelines are drafted in a manner which allows for different approaches and individual practices. This is due to the nature of internal models, which are specific to the undertakings and which cover specific risks and processes. Therefore, the Guidelines on internal models are more general in their approach. A similar approach is being applied in the area of governance and ORSA, where the Guidelines are oriented towards the outcome achieved, rather than the concrete means used by the undertaking, which would take into account the nature, scale and complexity of their business.
- On the other hand, in the area of the standard formula for example, Guidelines are of a more prescriptive nature: the standard formula is a standard that should apply to undertakings and similar risks in a uniform manner. Also in the choice of undertaking-specific parameters, in line with the Solvency II Directive, relatively prescriptive Guidelines have been drafted with regard to the quality of the data that should apply to all undertakings.
- The Guidelines are intended to be self-standing and not be dependent on the explanatory text in order to be understood or effective. Some papers contain more explanatory text than others. This may be to indicate how the Guidelines could be applied in particular cases or circumstances, but where it is not appropriate to prescribe an approach which should be complied with. In other areas, for example where complex calculations are necessary, the explanatory text may be used to explain or illustrate the approach and sometimes contains detailed examples. It should be noted that the consultation focuses on the Guidelines and not on the explanatory text: the explanatory text will not be translated, nor subject to the comply-or-explain mechanism.

5.3. Convergence will take time to establish. Based on the observed practices and compliance with the Guidelines, as well as developments in the market or in regulation, areas for further development will appear after the date of application of Solvency II. As part of this, EIOPA shall consider whether more prescriptive approaches are needed in order to promote greater

convergence of supervisory practices in the future. In particular, where Solvency II introduces areas that are not covered in existing regulations, for example group supervision (in particular the different levels of sub-group supervision), or provides for a different approach (for instance the prudent person principle), some Guidelines may seem more general or principle-based than current regulations.

- 5.4. To achieve convergent practices while ensuring that the measures remain proportionate, the Guidelines introduce in some areas further details on criteria established in the Solvency II Directive or draft implementing measures, taking the form of qualitative criteria or quantitative thresholds. In developing these, EIOPA has taken care, on a case-by-case basis, that these are justified in the light of proportionality and convergence considerations and no policy decisions are being made which would be contradicting the (intention of the) Solvency II Directive or the draft implementing measures.

6. Preparatory guidelines

- 6.1. The Guidelines on internal models, ORSA and governance that are part of the preparatory package are included in the final set of draft Guidelines for SII (reporting will be included in the second set of GL). In finalising the draft Guidelines for the first day of application of SII, EIOPA took care to safeguard the stability of the package, while enabling the necessary re-insertions of Guidelines that were omitted for the purpose of the preparatory phase and the necessary deletions or redrafting of some Guidelines. Stakeholders are asked to focus their comments on the parts that had not been consulted on before, which are being highlighted in the draft documents.