

*Certain parts of this Chapter of the Supervisory Handbook have been omitted from the publication. These omitted sections contain confidential information that is integral to the effective functioning of the supervisory review process.*

# EIOPA SUPERVISORY HANDBOOK

## Supervisory Review Process

*The Supervisory Handbook recommends good practices to National Supervisory Authorities (NSAs) for the supervision of insurance and reinsurance undertakings and groups. The recommendations provided to NSAs through this Chapter should not be interpreted as legally binding nor as applicable in all cases to all undertakings and groups. When following the guidance from the handbook, NSAs are always expected to implement a risk-based approach, to use their supervisory judgment, and to take into account the specific risks and characteristics of each undertaking or group under their supervision.*

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# CONTENTS

<b>1. Introduction</b>	<b>3</b>
<b>2. Supervisory Review Process – the Process</b>	<b>5</b>
<b>Chapter 1: Risk Assessment Framework</b>	<b>5</b>
<b>Section 1: Overview of the risk assessment cycle</b>	<b>5</b>
<b>Section 2: Impact Assessment</b>	<b>7</b>
<b>Sub-section 2.1: Introduction</b>	<b>7</b>
<b>Sub-section 2.2: Background</b>	<b>7</b>
<b>Sub-section 2.3: Impact Assessment process</b>	<b>8</b>
<b>Section 3: Risk Classification</b>	<b>12</b>
<b>Sub-section 3.1: Introduction</b>	<b>12</b>
<b>Sub-section 3.2: Background</b>	<b>13</b>
<b>Sub-section 3.3: Approach to risk classification</b>	<b>14</b>
<b>Section 4: Business model analysis within the supervisory risk assessment</b>	<b>24</b>

## 1. INTRODUCTION

- 1.1 This supervisory handbook recommends good practices to EIOPA's members and observers for the supervision of 'insurance and reinsurance undertakings and groups'<sup>1</sup> carrying on life and non-life business.
- 1.2 The purpose of the handbook is to support National Supervisory Authorities (NSAs) to deliver optimal supervisory outcomes within the framework of Directive 2009/138/EC (Solvency II)<sup>2</sup>, and also foster convergence of supervisory practices amongst EIOPA members and observers.
- 1.3 The Handbook is based on Article 29(2) of the EIOPA Regulation<sup>3</sup> which allows EIOPA to develop practical instruments and convergence tools to promote common supervisory approaches and practices.
- 1.4 Solvency II requires a pan-European, risk-based, proportionate and prospective approach to the supervision of undertakings.
- 1.5 EIOPA has developed Guidelines that outline the principles and overall process to be followed by NSAs when conducting the supervisory review process (SRP).<sup>4</sup> This handbook is intended to complement that work and the good practice content has been developed to reflect the key characteristic of the SRP, these are:
  - a. risk-based;
  - b. forward-looking;
  - c. proportionate; allows for the use of supervisory judgement rather than being prescriptive; and
  - d. fosters supervisory convergence.
- 1.6 The handbook is not binding and therefore will not be used as a means to assess NSA's conduct of supervision.
- 1.7 The intention is that the good practices can be applied by NSAs. However, when applying the recommended good practices, NSAs may need to tailor the approach. This may be at the level

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<sup>1</sup> Hereafter referred to as 'undertakings'.

<sup>2</sup> Insurance and reinsurance undertakings operating within the territories of EIOPA's member and observers may be subject to other 'prudential' requirements if they are, for example, part of a financial conglomerate or a designated global systemically important insurer. The handbook (currently) only considers supervisory activities stemming from the requirements of Solvency II.

<sup>3</sup> OJ L 331, 15.12.2010, p. 48–83.

<sup>4</sup> See Article 36 of Directive 2009/138/EC.

of the NSA, for example in order to reflect the national supervisory structure and powers<sup>5</sup>, or the specificities of the local market. It may also be at a supervisory level in order to reflect either the experience of the supervisors involved or the nature of the supervised entity, such as whether it is life or non-life, its lines of business or its business model. Furthermore, it is recognised that some of the good practices may not be appropriate in particular Member States, for example due to local administrative laws or other legal restrictions.

- 1.8 In general, the content of the handbook does not repeat the requirements set out in the Solvency II legal provisions<sup>6</sup>, which are widely available and accessible. However, within each chapter, either as part of the text or as an Annex, references are provided to the main articles or guidelines to assist supervisors to place the good practices within the context of the relevant Solvency II requirements.
- 1.9 The content of the handbook will be further developed and updated as needed, including on the basis of feedback from NSAs.

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<sup>5</sup> NSAs have different responsibilities and powers for example in terms of the types of financial sectors which they supervise and whether they address market conduct as well as prudential issues.

<sup>6</sup> These texts are the Directive (2009/138/EC), delegated acts, implementing technical standards and guidelines.

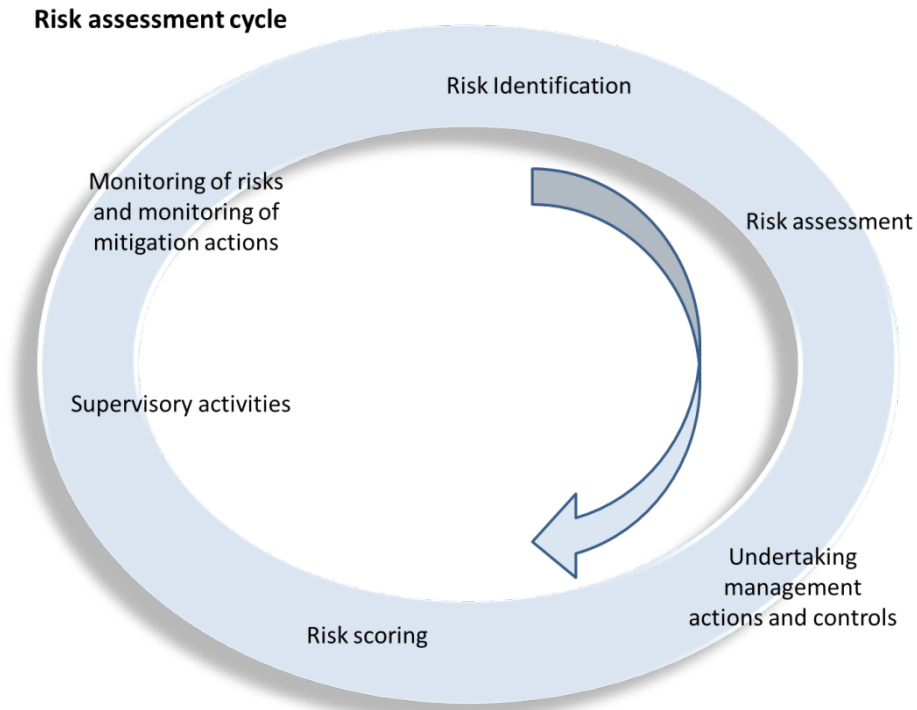
## 2. SUPERVISORY REVIEW PROCESS – THE PROCESS

### CHAPTER 1: RISK ASSESSMENT FRAMEWORK

#### SECTION 1: OVERVIEW OF THE RISK ASSESSMENT CYCLE

- 2.1. The scope of this good practice covers both individual and group perspectives. The departure point is the individual perspective and some group specific issues are referred to when needed.
- 2.2. The risk assessment cycle is one part of the supervisory review process (SRP) that is detailed in the SRP Guidelines. It is the process through which (groups of) insurance undertakings are assessed on a periodic basis in order to gain a clear understanding of the risks the undertakings face or may face and the undertaking specific controls that are in place. By having this understanding the supervisor is able to take appropriate measures where needed.
- 2.3. The SRP comprises three stages:
  - a) Risk Assessment Framework (RAF), including impact and risk classification;
  - b) Detailed analysis; and
  - c) Supervisory measures.
- 2.4. The risk assessment cycle is conducted throughout the SRP and comprises the following steps that are also shown in the diagram 1, below:
  - d) Risk identification
  - e) Risk assessment
  - f) Undertaking management actions and controls
  - g) Risk scoring
  - h) Supervisory activities
  - i) Monitoring of risks and monitoring mitigating actions

**Figure 1: The risk assessment cycle**



**Definition of and considerations of risk, gross and net**

- 2.5. Risk in the context of the SRP Handbook is a risk with the potential to cause damage to policyholders and/or beneficiaries, or undertakings, jeopardising one or more of the objectives of the NSA.
- 2.6. As the terminology ‘gross’ and ‘net’ have variable meanings within the Solvency II context, for the purpose of risk-based supervision it is important to define what is meant by gross and net risk as follows:
  - a) The gross risk is the probability of occurrence and impact inherent in a particular product, line of business, sector or undertaking without taking into consideration current management actions or controls.
  - b) Net risk is the (residual) risk after taking into consideration current management actions / controls.
- 2.7. Usually, the assessment of the risk includes two dimensions:
  - a) the level of impact (the potential damage that a risk could pose for an individual issue or for the undertaking as a whole); and
  - b) probability (the likelihood of occurrence).

- 2.8. NSAs are recommended to consider both dimensions. The ‘impact of a risk’ should not be confused with ‘the impact of the potential failure of an undertaking’, a concept also addressed in the SRP.
- 2.9. Risk Management actions/controls: are activities/measures applied by the undertaking to mitigate the inherent/gross risks.
- 2.10. Impact assessment of an undertaking is the process by which an NSA classifies insurance and reinsurance undertakings according to the damage the undertaking’s failure could cause to policyholders, the market or the objectives of the NSA (see section 2).
- 2.11. Risk classification is the process of identifying, assessing and scoring the risks (during the risk assessment cycle) that an undertaking or a group faces or may face. The risk classification within the risk assessment is part of a larger process of the supervisory review process, in which all the relevant risks an undertaking or group faces or may face are identified, assessed, classified, acted upon (risk reduction / upon mitigation) and monitored (see section 3).
- 2.12. The combination of impact assessment and risk classification should be used by supervisors for the prioritisation of supervisory tasks/activities.

## SECTION 2: IMPACT ASSESSMENT

### SUB-SECTION 2.1: INTRODUCTION

- 2.13. This section sets out the key elements that are recommended for NSAs to consider when carrying out an impact assessment of an undertaking during the risk assessment.
- 2.14. Sub-section 2 provides a brief discussion on the background for the section, defines important terminology and sets out the objectives for conducting impact assessments.
- 2.15. Sub-section 3 outlines elements of the process of conducting impact assessments and provides recommendations of good practice to assist NSAs in implementing the process.

### SUB-SECTION 2.2: BACKGROUND

- 2.16. This section of the Handbook needs to consider Guideline 15 of EIOPA Guidelines on the Supervisory Review Process for the individual impact assessment and Guideline 16 for the group impact assessment.

### **Definitions**

- 2.17. Impact assessment is the process by which an NSA classifies insurance and reinsurance undertakings according to the damage the undertaking's failure could cause to policyholders, the market or the objectives of the NSA.
- 2.18. Impact classification may be performed at different insurance business levels i.e. Life, Non-Life, Reinsurance and Composites. This may be combined with an insurance market level assessment.

### **Supervisory outcome**

- 2.19. The classification of impact means that an NSA will set thresholds to define how to classify undertakings in a four-scale classification as defined in the SRP Guidelines. By aligning impact classifications, NSA's can in a meaningful way compare the impact of the failure of a life undertaking with that of a non-life undertaking or composite even though the metrics for the calculation of the underlying impact may not be the same.

## **SUB-SECTION 2.3: IMPACT ASSESSMENT PROCESS**

- 2.20. The good practices for establishing an impact assessment process are detailed below under the following key elements:
- i. Frequency
  - ii. Classifying impact quantitatively
  - iii. Qualitative factors and the use of judgement
  - iv. Internal governance around the process of setting impact categories
  - v. Metrics for impact measurement (types of categories)
  - vi. Thresholds for metrics (setting triggers)

### **i. Frequency**

- 2.21. NSAs are recommended to assess impact on an annual basis through quantitative indicators.
- 2.22. An annual update provides an opportunity to analyse changes or movements in undertakings within and between impact classifications. The frequent review of impact allows NSAs to assess the stability of the population of the classifications and/or to establish whether it might be necessary to recalibrate their classification parameters or amend the

selection or manner of combining metrics to classify undertakings. This will ensure consistency, structure and comparability of classifications and the integrity of the methodology involved in achieving it.

#### **ii. Classifying impact quantitatively**

- 2.23. NSAs are recommended to derive the impact classification for an undertaking by means of using either a combination of impact metrics or a single impact metric. NSAs are recommended to determine the number and type of impact metrics they use based on their own market characteristics.

#### **iii. Qualitative factors and the use of judgement**

- 2.24. NSAs are recommended to retain the ability to use judgement based on qualitative factors in assessing the potential impact of an undertaking in addition to and in support of the quantitative process. Judgement can be used in the process at a number of points, including whether an undertaking appears to be in the appropriate classification, whether the right metrics are used in the methodology, and in setting the parameters that separate undertakings into the various classifications.
- 2.25. The use of judgement as part of the impact assessment can be used as a type of 'sense-check'; ensuring that the impact assigned is suitable and appropriate in the circumstances.
- 2.26. Specific local market or individual undertaking-specific factors may lead to the requirement to 'override' the quantitative assessment of an undertaking's impact classification. It is important that appropriate governance applies to such overrides in order to maintain the integrity of the impact models and metrics being used.

#### **iv. Internal governance around the process of setting impact categories**

- 2.27. NSAs are recommended to develop and document appropriate governance processes. There are a number of areas in relation to the process around impact classification where it is recommended that NSAs could develop appropriate governance structures or processes. These include the selection of impact metrics that drive the classification of undertakings, the frequency of updating metrics and setting and monitoring the thresholds or parameters between classifications.
- 2.28. In circumstances where an NSA needs to override or adjust the quantitative impact classification, NSAs are recommended to develop internal governance arrangements, e.g.

clear allocation of responsibilities and a defined decision-making process, to oversee and approve such adjustments.

- 2.29. Governance arrangements ensure consistency of approach and reliability of data within the NSAs and acts as a sense-check, particularly where supervisory overrides have been utilised. Effective governance enhances the integrity of the classifications and increases the buy-in of supervisors to the classification of an undertaking by producing reliable information on which they can plan their activities. This also increases transparency within the NSA – with clear audit trails and communications.

**v. Metrics for impact measurement (types of categories)**

- 2.30. NSAs are recommended to approach the impact assessment using selected metrics when assessing impact. The metrics may be different for life, non-life, composite undertakings and reinsurance undertakings. As impact metrics represent a proxy for the level of damage an undertaking's failure could cause to policyholders, the market or the objectives of a NSA, the selection of appropriate (valid and reliable) metrics is important. The number and type of metrics needed to reflect potential impact can vary depending on the type of business written in a jurisdiction, and/or the population (and related complexity thereof) of undertakings supervised.
- 2.31. NSAs are recommended to use metrics that reflect different aspects of impact, for example, market share, concentration or dominance in different business lines or indeed in total business written. There could be circumstances in which an undertaking writes typically small amounts of business but is a leading player in a niche market.
- 2.32. NSAs may wish to consider the business lines and products written by undertakings in determining their potential impact and will need to identify metrics that serve as a useful proxy for ranking such impact.
- 2.33. Another aspect of metric selection or combination to be considered is whether gross and net of reinsurance and other risk mitigation techniques, or gross only or net only metrics are recommended to be used. How such metrics are combined can make a big difference to impact rankings or classifications depending on the composition of the population of undertakings involved.
- 2.34. NSAs are recommended to use metrics addressing 'Premium' for non-life business and 'Technical Provisions' for life business. NSA may decide to use more metrics than this two.

When selecting a potential suite of impact metrics, whether they are intended to be used individually, or in combination, it should be borne in mind that different metrics can reflect different aspects of the impact of potential failure. Some examples of such metrics are set out below<sup>7</sup>:

- 2.35. Size/Business model Based:
- Gross/Net Technical Provisions;
  - Gross/Net Premium
  - Total Assets or Liabilities;
- 2.36. While asset or premium based metrics offer proxies for size, using gross and net metrics can reflect important differences between the impact undertakings may represent depending on the makeup of undertakings in a jurisdiction.
- 2.37. Capital based:
- Regulatory capital requirements (e.g. SCR in Solvency II);
- 2.38. Dominance based:
- Market Share;
  - Number of contracts;
  - Number of policyholders.
- 2.39. Market share metrics can be useful impact indicators in concentrated markets or to indicate situations where undertakings are significant players in specific lines of business or in niche markets.
- 2.40. As part of the impact assessment, NSAs are also recommended to consider market conduct and cross-border conduct issues. This could include using metrics involving the number of policyholders, number of complaints, splitting other metrics between domestic and international or similar approach.
- 2.41. The use of more metrics to the impact assessment calculation may not necessarily add to the quality of the result.

#### **vi. Thresholds for metrics (setting triggers)**

- 2.42. NSAs are recommended to select impact metrics relevant to their population of undertakings and combine them in such fashion as to provide a meaningful ranking of

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<sup>7</sup> Please note that this is neither a suggested nor exhaustive list of metrics, but is typical of the type of metric currently used by some NSAs.

undertakings by potential impact, and to establish thresholds between impact classifications and set trigger points to prompt supervisors to review significant movements in reported metrics.

- 2.43. The setting of thresholds is a judgement call for each NSA.
- 2.44. NSAs are recommended to have decision points or judgements by supervisors to ensure that an undertaking could not move from one classification to another without supervisors being aware of it or approving it. Hence there is a need to establish trigger points to identify significant movements in impact metrics and alert functionality to notify supervisors when such trigger points are reached so they may be prompted to review the situation to establish whether they need to take action or amend their view of the undertaking.
- 2.45. NSAs are recommended to monitor moves from marginal zones of one classification to marginal zones of another (e.g. an undertaking's impact score moving from the top of one classification to the bottom of another or vice versa). Such moves may be temporary in nature and may not be reflective of the ongoing impact of an undertaking, and as such it may make sense to establish a required time period for which a classification must be maintained in metric terms before it can be accepted by supervisors in operational terms.
- 2.46. The rationale for setting thresholds and triggers is to ensure consistency of approach. NSAs will be able to group undertakings into their classifications, establish peer groups and compare undertakings against each other by using consistent metrics.
- 2.47. NSAs are recommended to establish quantitative thresholds based on results from their combination (where more than one metric is used) of impact metrics in order to set impact classifications for undertakings. The thresholds chosen will need to be reflective of the size and type of insurance market regulated by the NSA and the nature, scale and complexity of the undertaking's regulated. As such, setting the thresholds will result from a subjective judgement.

## SECTION 3: RISK CLASSIFICATION

### SUB-SECTION 3.1: INTRODUCTION

- 2.48. This section sets out the key elements that are recommended for NSAs to consider when

deciding on the risk classification of an undertaking during the risk assessment. It is divided into three sub-sections.

- 2.49. Sub-section 2 provides a brief outline of the section defines important terminology and establishes the objectives and desired supervisory outcome for the risk classification.
- 2.50. Sub-section 3 provides details of the key elements that are recommended to comprise a NSAs approach to risk classification.

### **SUB-SECTION 3.2: BACKGROUND**

- 2.51. This section of the Handbook needs to consider Guideline 7, 12, 13 and 17 of EIOPA Guidelines on the Supervisory Review Process for the individual risk classification and Guideline 7, 12, 13 and 18 for the group risk classification.

#### **Definition of risk classification**

- 2.52. Risk classification is the process of identifying, assessing and judging the risks that an undertaking or a group faces or may face. The risk classification within the risk assessment is part of a larger process, the supervisory review process, in which all the relevant risks an undertaking or group faces or may face are identified, assessed, classified, acted upon (risk reduction / upon mitigation) and monitored.
- 2.53. This section of the Handbook does not cover the supervisory assessment activities that supervisors would carry out during the full supervisory review process.

#### **Objective of risk classification**

- 2.54. The principal objective of risk classification together with the impact classification is to ensure that in a clear and transparent way supervisory resources are directed to undertakings that present the greatest risk to policy holders (and/or to financial stability priority to the others). It is also to ensure that supervisors carry out supervisory actions that address the identified risks or risk areas within an undertaking by conducting in-depths analysis/investigation and actions to weaken/reduce the risks.
- 2.55. The assessment of the likelihood and impact of the risk crystallising is undertaken by the supervisor who judges the effectiveness of the risk reducing activities of the undertaking.

#### **Supervisory outcome**

- 2.56. The outcome of risk classification is the product of an in-depth process of risk identification and assessment that begins ideally with the external environment and steadily moves

towards an assessment of the individual situation of the undertaking. During this process, an increasingly clear picture of the most relevant risks emerges. Supervisory attention will naturally focus on those risks that jeopardise the continuity of an undertaking to ensure the adequate protection of policy holders and beneficiaries.

### **SUB-SECTION 3.3: APPROACH TO RISK CLASSIFICATION**

#### **General principles**

2.57. NSAs are recommended to consider the following elements when developing and implementing an approach to risk classification. It should be noted that these elements neither define a process nor do they suggest the order of such an approach.

- i. Analysis / assessment of risks
- ii. Analysis / assessment of risk controls
- iii. Relevant risk drivers to the insurance sector;
- iv. Relevant risks to the insurance sector;
- v. Metrics for measuring the risk (covered by this section);
- vi. Outcome of the risk classification (covered by this section)
- vii. Frequency (covered by this section)

#### **i. Analysis / assessment of risks**

2.58. When assessing the risks (whether related to an individual undertaking or thematic, i.e. a specific risk identified affecting various undertakings with similar characteristics), the NSA is recommended to take into account not only quantitative information about the scope and severity of the potential problem but also qualitative factors.

2.59. NSAs are recommended to initially focus to the extent possible on the inherent / gross risks, abstracting from any existing controls during risk analysis. The operation of the controls forms part of the next stage of the risk analysis, which also includes an analysis of the effect which the controls have on the inherent risks.

2.60. Each and every risk to be assessed has its own assessment approach. Some risks may be assessed by analysing metrics, such as underwriting or market risks while the assessment of for example 'compliance risk' will focus on issues like business and performance, system of governance, including ORSA; risk profile; valuation for solvency purposes and capital management.

- 2.61. In case of assessing the risks at the level of a group, NSAs are recommended to consider the following group-specific issues:
- a) Intra-group transactions;
  - b) Complexity and interconnectedness of the group;
  - c) Interconnectedness with other financial sectors;
  - d) The group risk profile including any diversification effects and risk concentrations, and risk transfer across the group;
  - e) Aspects of the group governance and group strategy including any conflict or any potential conflict of interests;
  - f) Aspects of the group-wide risk management, including any centralized risk management functions;
  - g) And the group's management of its group capital, including transferability and allocation within the group.

**ii. Analysis / assessment of controls**

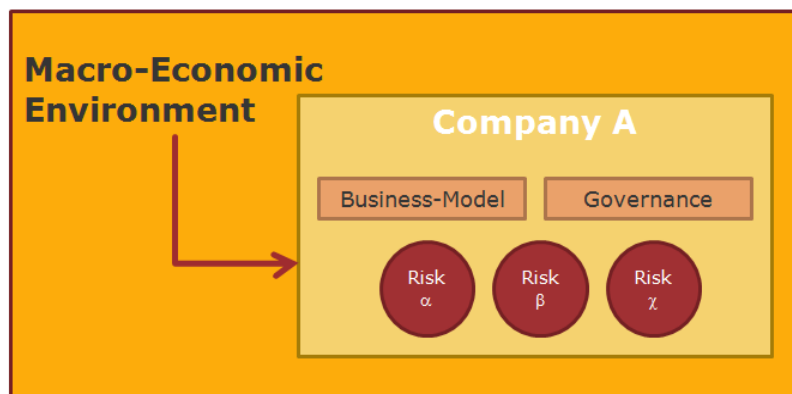
- 2.62. Analysis of the risk controls serves to gain an insight into the quality of the risk controls for the individual risks and into the resulting residual risks within the organisation. In the absence of adequate controls, there is an enhanced probability of the risk giving rise to a risk event or leading to a heavier impact.
- 2.63. NSAs are recommended to distinguish the following forms of control (control categories):
- a) Risk-specific controls;
  - b) Overall risk controls (undertaking specific);
  - c) Specific group controls, e.g. risk-reducing actions at the level of the group.
- 2.64. Risk-specific controls are specifically aimed at reducing one single risk category, e.g. reinsurance recoverables collection procedures are aimed specifically at reducing credit risk. The overall risk controls may exert a risk-reducing effect on inherent / gross risks through such means as a management structure and composition matching the size and complexity of the operations, an effective decision-making process, effective strategic planning and the encouragement of a corporate culture marked by an awareness of risks and the need for risk control. This means that these controls do not relate to a single risk, but have a risk-reducing effect on the entire risk profile of the undertaking.
- 2.65. In a group context risk management and internal control are issues of great importance

since the group governance strategy needs to be adequate to cover all entities in the scope.

- 2.66. In particular, when the risk management or internal control system are centralised at the group level, the group supervisor is recommended to assess the adequacy of the centralised system for all entities that are covered. When the risk management or internal control system are decentralized, the group supervisor is recommended to assess the adequacy of the integration of all individual elements into the overall group system of governance.

**iii. Relevant risk drivers to the insurance sector**

- 2.67. The risks an undertaking face or may face (in the figure below risk $\alpha$ , risk  $\beta$  and risk $\chi$ ) are influenced by and could be seen in the context of the environment in which they operate (environmental or macro risk), the business which they are carrying out (business model risk) and the quality of the governance established to downsize the risks.



- 2.68. The analysis of these elements (they can be called ‘risk drivers’) is forward-looking in nature and is essential in order to obtain a clear picture of future risks. Each will have an effect on the significance of the specific risks types identified later in the next section.
- 2.69. NSAs are recommended to include these three factors (environmental/macro, business model and governance) in the risk assessment. The assessment of environmental risks, the business model analysis and the assessment of the system of governance could be separate activities within the risks assessment or could be one of the risks to be considered within the list, mixed approaches could be used.
- 2.70. The rationale for assessing these risk drivers can be found in the deeper understanding of the risk factors such as underwriting or market risk. By understanding the drivers behind

some risks it is easier to also understand the risk reducing activities for underlying risks.

- 2.71. Overall, this analysis of risk drivers makes clear which individual risks have the greatest potential impact and likelihood and should therefore be given priority in the subsequent steps.
- 2.72. The environmental or macro risk (driver) is the driver for risks occurring because of external influences, such as economic (non)growth, insurance market changes, changes in population and so on. By nature, the undertakings cannot really influence these movements.
- 2.73. The business model risk (driver) is the driver for risks occurring because of the business model of the undertaking. The risks on business models and their analysis are covered in section 4 of this chapter.
- 2.74. The business model risk (driver) for groups may be complex compared to individual level. In fact, the individual strategy is in many cases determined by the group and only knowing all the individual strategies is possible to understand the group strategy.
- 2.75. The governance risk (driver) is the driver for risks occurring because of malfunctioning of governance structures within the undertaking/group. Such as a poor risk management or internal control system or e.g. a poor underwriting policy.
- 2.76. If there is a college the relevant supervisory authorities are recommended to take into account the outcome of any relevant market-wide analysis that has been shared within the college. In this regard the group supervisor is recommended to identify and take a pro-active role and clear responsibility on what information should be shared.

#### **iv. Relevant risks to the insurance sector**

- 2.77. The categorisation of risks identifies the main types of risks for undertakings. NSAs are recommended to consider the following risk categories:
  - a) Underwriting Risk
  - b) Market risk
  - c) Credit Risk
  - d) Operational Risk
  - e) Other Risks
- 2.78. The table in Annex 1 shows a definition of the relevant risks for the purposes of this Handbook to promote a common understanding of risks, as given and defined in the

Solvency II framework (table 1). Additional risks (which are not covered by the standard formula) are listed and defined in table 2. However, the list is not exhaustive, as there may be risks or events which can occur but are not known yet.

- 2.79. The risks inherent in an undertaking's internal model are to be taken into consideration during the assessment of the relevant risk categories. The approach is not elaborated on this paper due to internal model risk being unique to each undertaking.

#### **v. Metrics for risk measurement**

- 2.80. When measuring the risks in order to classify them, various criteria and measures (metrics) may be used, depending namely on the type of undertaking concerned and the characteristics of the relevant market.
- 2.81. NSAs are recommended to consider not only quantitative criteria but also qualitative, and their use does not lead to a mechanistic risk assessment by the supervisory authority based only on thresholds and scoring.
- 2.82. Although the initial step of the risk classification is usually an automated process, NSAs are recommended that the assessment of risk be not totally automated but relies on analysis and judgment by the supervisor. In particular, NSAs are recommended to not rely entirely on an automated process at least for the assessment on the risks drivers (environment or macro, business model, governance).

#### **vi. Outcome of the risk classification**

- 2.83. NSAs are recommended to adopt an approach to the supervisory risk classification that ensures that an accurate and up-to-date outcome is achieved, and that which has been carried out in a manner that is sufficiently robust. This is necessary so as to accurately inform the supervisor's approach to prioritization of supervisory work and areas of supervisory focus within, and between undertakings.
- 2.84. The group risk classification is not to be a simple summation of the individual risk assessments, but a full risk classification process on itself. Consideration ought to be given by the group supervisor to where the risks originate (taking into account all relevant information given by NCA concerned), and whether the risks are exacerbated or diversified at the group level.

#### **vii. Frequency**

- 2.85. One of the aims of the risk classification is together with the impact classification, to

prioritise supervisory actions. These are usually set on an annual basis and therefore NSAs are recommended to perform for all undertakings the risk classification as described at least annually.

- 2.86. The fact that the risk classification is at least annual does not undermine the fact that the risk assessment is in fact a continuous process and the scope and length of this process is to be proportionate to the undertaking being assessed.
- 2.87. In some cases, when data is available on a more frequent basis and the risks are considered to be more volatile, e.g. market risk, specific assessment and classification of that specific risk is recommended to be performed.

#### Annex 1: Relevant risks to the insurance sector

Table 1: Risks Categories and definitions are based on the Solvency II Directive

Risk Category	Risk Sub-Category	Definition
Market risk		The risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments, reflecting also structural mismatch between assets and liabilities, in particular with respect to the duration thereof.
	Equity risk	The sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of equities.
	Interest rate risk	The sensitivity of the values of assets, liabilities and financial instruments to changes in the term structure of interest rates, or in the volatility of interest rates.
	Property risk (it might be also called: real-estate)	The sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of real estate.

Risk Category	Risk Sub-Category	Definition
	risk)	
	Currency risk	The sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of currency exchange rates.
Credit risk		The risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations.
	Spread risk <sup>8</sup>	The sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure.
	Counterparty default risk	The risk of possible losses due to unexpected default, or deterioration in the credit standing, of the counterparties and debtors of insurance and reinsurance undertakings, over the following 12 months
	Market risk concentration	Additional risks to an insurance or reinsurance undertaking stemming either from lack of diversification in the asset portfolio or from large exposure to default risk by a single issuer of securities or a group of related issuers.

<sup>8</sup>.According to the article 13 (32) of the SII Directive, credit risk consists of the counterparty default risk, spread risk and market risk concentrations. However provisions for the Solvency Capital Requirement calculated using the standard formula classified spread risk and market risk concentrations as one of the market risk sub (modules).

Risk Category	Risk Sub-Category	Definition
Operational risk		The risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events. It shall include legal risk, and exclude risks arising from strategic decisions, as well as reputation risk

Underwriting risk (it might also be called: Insurance risk)		The risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.
	Longevity risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of mortality rates, where a decrease in the mortality rate leads to an increase in the value of insurance liabilities.
	Mortality risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of mortality rates, where an increase in the mortality rate leads to an increase in the value of insurance liabilities.
	Disability- Morbidity risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend or volatility of disability, sickness and morbidity rates.
	Lapse risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations,

		renewals and surrenders.
	Expense risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of the expenses incurred in servicing insurance or reinsurance contracts.
	Revision risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the level, trend, or volatility of the revision rates applied to annuities, due to changes in the legal environment or in the state of health of the person insured.
	Catastrophe risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from significant uncertainty of pricing and provisioning assumptions related to extreme or irregular events.
	Premium and reserve risk	The risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements.

Source: SII-Framework

Table 2: Other risks (not exhaustive)

Some of the definitions listed in the below table are not based on the Solvency II Directive. They were provided only for the purpose of this Handbook.

Environmental or macro risk		The risks occurring because of external influences, such as economic (non)growth, insurance market changes, risks arising from systemic events, procyclicality, changes in population and so on. By
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		nature, the undertakings cannot really influence these movements.
Business (model) risk		The risks occurring because of the business model of the undertaking. Strategic choices can influence the specific risks within the undertaking.
Governance risk		The risks occurring because of malfunctioning of governance structures within the undertaking. Such as risks arising from a poor risk management or internal control system or e.g. a poor underwriting policy. This includes outsourcing, key functions, the use of the internal model by the undertaking
Liquidity risk		The risk that insurance and reinsurance undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due.
Reputational risk		Reputational risk is the risk of loss resulting from damages to a firm's reputation, in lost revenue or destruction of shareholder value
Risks specific to the group		In the context of the risk assessment this includes contagion, intra-group transactions and where the undertakings in the group are reliant on the services provided by other undertakings in the group. It also includes fungibility and risks arising from unregulated entities in the group. Moreover, reputational risk and concentration risk have their special dimension at the group level due to interconnectedness of entities in the group; this also may be analysed in the context of the group

		risk.
Sustainability risk		An environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential negative impact on the value of the investment or on the value of the liability.
ICT risk		Any reasonably identifiable circumstance in relation to the use of network and information systems which, if materialised, may compromise the security of the network and information systems, of any technology dependent tool or process, of operations and processes, or of the provision of services by producing adverse effects in the digital or physical environment.

## SECTION 4: BUSINESS MODEL ANALYSIS WITHIN THE SUPERVISORY RISK ASSESSMENT

This section is available in the specific chapter of the Supervisory Handbook on business model analysis including digitalisation, available at this [link](#).

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