IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

Advice on Solvency II Review

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European Insurance and Occupational Pensions Authority

EIOPA STAKEHOLDER EVENT ON THE 2020 REVIEW OF SOLVENCY II ON 23 OCTOBER 2020

IRSG WRITTEN COMMENTS

MINORITY VIEW

This document has been adopted as required by a majority of members of the IRSG. The lack of involvement of consumer experts in important Solvency II issues was raised as a concern during the adoption process by some members. These members have identified an imbalance of resources between industry members and consumer members. They have also highlighted a lack of summaries of the issues for end clients, and in plain English. They point to the EIOPA documents being written in too technical terms and without a clear explanation of the potential impacts for end clients, which causes difficulty for them in assessing issues and consulting with their members/stakeholders. They also expressed disagreement with some of the positions taken in this document relating to capital requirements and additional supervisory proposals.

GENERAL COMMENTS

The IRSG welcomes the opportunity to provide comments following the EIOPA stakeholder event, and would like to highlight the following main concerns:

We question the objective of a “balanced approach” - this appears to be pre-judging the outcome and endorsing the levels of capital required under the current provisions. We consider that the changes made should be on the basis of justification/need. We also consider that the approach in itself is in fact not balanced, given that (i) some of the most negative proposals are left out of the calculations and (ii) calculations are based on a single point in time. We also note that capital levels under Solvency II are already very high and provide a level of policyholder protection (1-in-200 years loss events are covered) which is unprecedented in comparison to other insurance regulatory regimes. Taking this starting position as the target, and indeed further increasing requirements when all proposals are included, is likely to harm the competitiveness of the European insurance sector and lead to adverse consequences for customers.

We note also that the consideration of balance is at the level of the entire HIA which tends to miss the differing impacts at local country levels; these differences are important factors to consider in the assessment.

We are concerned that some of the changes are likely to lead to greater volatility in solvency positions. The solvency position of insurers should be reasonably stable and present a meaningful picture of future prospects. As such, solvency ratios must not be distorted by heavy short-term fluctuations. EIOPA's proposals are likely to make solvency ratios even more volatile, especially during periods of crisis, and could encourage more procyclical behaviours and short-term views. Moreover, excessive artificial volatility could prevent insurers from offering products with long-term guarantees and from contributing to the long-term funding of the European economy. The IRSG also highlights that capital requirements should be risk based. Incorrect estimation of risks can have negative consequences, including inappropriate incentives which themselves have risk consequences, may lead to withdrawal of certain products or failure to invest in certain asset classes. Key concerns in this respect are extrapolation, volatility adjustment and interest rate risk proposals. We also note the impact of the factors which constrain eligibility for long term equity investment.

During the event, EIOPA presented the results of the Holistic Impact Assessment (HIA) exercise. Those results are not completely representative of the European sector. 392 undertakings participated in the HIA; this is a subset of the 2,797 insurance undertakings which are subject to Solvency II regulation. The participants included larger players and internal model users, and the results may as a consequence show a picture which is not representative and which may not properly reflect interest rate risk implications as the standard formula implications do not apply to internal model users.

The proposed changes to Solvency II should also be tested in different economic and financial environments. For the Volatility Adjustment, for example, it is crucial that the situations of great exaggeration of spreads, as happened under the 2008-2011 financial crisis, should be tested.

INTEREST RATE RISK

The IRSG has been vocal on this subject with several discussions with EIOPA. We would just note that it is crucial to justify the parameters for any new proposal in sufficient ways. As we are in a low interest rate environment, only a narrow sample of data can be used. We consider that this means it is necessary to justify calibrations using a qualitative risk analysis, going through the main triggers that could lower the interest rates in short term; ECB-actions, macroeconomic progress, and global investment market, some of which can also hedge the actual risk of interest rates lowering.

In addition, the IRSG was disappointed to see that EIOPA has not tested an appropriate floor to the model and continues to pursue a purely "data-driven approach" to the recalibration of the IRR submodule. IRSG considers that any IRR model should have a floor which is reflective of an economically justifiable lower bound to interest rates. IRSG agrees that this cannot be 0% but also considers that -2% is equally unlikely.

It is also necessary that the illiquid part of the stressed curves are derived via the Smith-Wilson extrapolation approach – this is necessary to create the correct capital requirements for long-term risks and therefore products. It is also vital for non-euro currencies with short LLP's which are currently penalized by EIOPA's proposed approach.

VOLATILITY ADJUSTMENT

The IRSG provided feedback on the apparent deficiencies that EIOPA had identified as part of its response to the consultation on the 2020 Review. Overall, the IRSG welcomes the improvements by EIOPA (normalisation of bond portfolio, increased GAR and improved country adjustment). However, it recommends that EIOPA reconsiders its proposals on the risk correction and liquidity adjuster which we consider not to be justified or appropriate, and which could lead to increased procyclicality.The IRSG notes that the current VA does not effectively compensate for artificial volatility in the Solvency II ratios of insurance undertakings because of the significant proportion of assets backing own funds which are not compensated for their volatility although they are included in all the market risk module computations. The excessive conservatism of the VA leads to significant undershooting for many insurers. Changes in market values should be better reflected in the changes of the best estimates to avoid overstating the losses passed onto the own funds of insurance undertakings.

EIOPA's proposed changes to the volatility adjustment do not fix undershooting situations and are likely to exacerbate conservatism for some contract portfolios (non-life and life with surrender options) because of application ratio 5. This factor is based on pure stand-alone product features, overstates the actual volatility and does not recognise the impact of safeguarding measures put in place through appropriate ALM.

Compensating artificial volatility should be a paramount concern in a market consistent risk based regime. The core issue here is the ability to reflect market prices for the sake of transparency and quality of up to date information on the one hand and to reflect the changes in the valuation of the best estimates of the liabilities. Failing to do so will inevitably distort the proper value of own funds. This target is key to the adaption to long term business characteristics which revolve around the choice of timing of purchase and sale of the assets aligned on long term strategies.

DYNAMIC VOLATILITY ADJUSTMENT

The IRSG is disappointed that EIOPA has not included any analysis of a standard formula DVA in its latest advice. EIOPA's testing of a standard formula approach was a welcome inclusion in the HIA, and the IRSG recommends that EIOPA works further in this area to ensure that the credit risks to which insurers are exposed are appropriately capitalised for.

Regarding the DVA in internal models, the IRSG supports Option 2: Stay with the current prudency principle and cover disincentives by pillar 2 measures on risk and investment management. The IRSG does not consider that EIOPA has provided sufficient evidence of the issues it aims to resolve with the Enhanced Prudency Principle and questions the need to increase regulatory burden and introduce potential cliff effects into the SCR calculation.

LAPSE RISK

The IRSG is disappointed that EIOPA is not proposing an adaptation of the calibration of the mass lapse risk. This risk bears a calibration which is not justified and which materially overstates any historical experience.

MACROPRUDENTIAL TOOLS

The IRSG considers that there is no need for new macroprudential tools as the current framework already effectively addresses most potential systemic risks in the insurance industry. The Covid-19 crisis for instance has not shown evidence of flaws at the macro level that would justify the need for new tools or requirements for insurers. On the contrary, there has been demonstration that the insurance sector has weathered the crisis well to date and that the regime has been able to capture all effects on both sides of the balance sheet and across all lines of business according to the experience so far. Insurers have not been forced sellers and there have not been liquidity issues. For instance we note that lapses have not exploded but rather slightly decreased. The Covid-19 crisis has also shown that pandemic risk is different from any type of economic cycle and was of a totally different nature to previous crises which the industry also came through effectively.

Solvency II already covers macroprudential aspects and allows early intervention by supervisors through the so called ladder of intervention between SCR and MCR. Other tools such as the reporting for Financial Stability and EIOPA biannual stress tests are part of the macroprudential monitoring. Recovery requirements through recovery plans and finance schemes as well as the escalation of supervisory powers in deteriorating financial conditions should suffice.

We consider that, rather than considering new instruments and measures, the focus should be on enhancing the effectiveness of LTG measures to fully reflect insurers' long-term oriented business model, and to mitigate artificial volatility and potential incentives for procyclical behaviour in extreme market situations. We also oppose the idea of countercyclical buffers at macroprudential level since they would not fit as such in a risk based system.

Additional specific comments follow.

Restrictions on dividends distribution:

- A blanket ban on distributions is not a suitable macroprudential instrument. Such an extensive intervention is disproportionate in principle.
- Blanket dividend suspension, regardless of individual undertakings' situations, are also harmful to the insurance sector, undermine the credibility of prudential regulation and lead to a range of adverse consequences including:
  - disruption of income flows for those investors (eg pension funds) which rely heavily on regular cash remittance,
  - disruption to capital and liquidity management within insurance groups, compromising their ability to effectively manage the solvency of their entities,
  - increase in cost of capital and damage to the ability of the insurance sector to raise further capital by creating market uncertainty and calling into question the underlying investment rationale and appeal of regular consistent dividends.
- Solvency II already provides a strong basis and governance framework for dividend distributions, already governed by multiple safeguards and constraints including:
  - continued and forward-looking solvency coverage requirement after subtraction of planned dividends in the ORSA
  - risk tolerance limits which are formal commitments embedded within the undertaking's governance and limit their ability to reduce the solvency position in times of stress.
  - boards' responsibilities towards ongoing viability and ultimately shareholder approvals
- Such measures should not be considered before the SCR has been breached. Under the current framework, supervisors have already extensive powers to intervene unilaterally after the SCR has been breached as part of the ladder of intervention.

Liquidity risk framework:

- Liquidity risks are moderate and mostly already addressed by existing provisions.
- Additional requirements should only be considered if it can be demonstrated by the supervisor that an insurer is subject to elevated liquidity risks.
- Measuring liquidity risk needs to be looked at from a full balance sheet perspective taking into account also the details on insurance contracts, assets and commitments to third parties – simplifications on measuring the risk can easily be misleading.
- Liquidity risks can be assessed by means of a double scenario where a market stress is followed by a lapse stress causing a total balance sheet effect. Typically insurers survive this type

of stress well as there is time to respond on the increased customer needs, the asset side provides sufficient liquidity without fire-sales with haircuts, and third party commitments are usually quite modest.

- Liquidity is best addressed in insurers' internal risk management process and fully considered and communicated in the ORSA process.

Any additional reporting requirements must balance the costs against the benefits:

- A large amount of data is already available to supervisors (eg S.06.02, S.13.01, S.18.01). The current EIOPA advice regarding the 2020 Review already proposes Liquidity Risk Management Plans (LRMPs).

- More reporting/information requirements would produce significant administrative burdens and necessitate additional IT investments at the expense of insurers and, ultimately, policyholders.

- In any case, a strong limitation of the scope of these reporting requirements would be required.

Further analysing procyclical issues, we consider that the equity dampener is not a fully effective tool and can easily end up with overshooting when a reduced shock applies to an already much reduced equity value in times of turmoil. It can even exacerbate volatility in the case of entity specific equity portfolios. We support approaches which are consistent with long term risk management and strategies and thus apply adequate calibrations that work all the time because of the resilience and capacity to avoid forced sales of the insurers.

LONG-TERM EQUITY

EIOPA's work on the Long Term Equity submodule is welcomed by the IRSG, and we consider that the proposals are moving in the right direction. It is important to note that the possibility to facilitate more extensive equity investments can contribute to the needed level of diversification and the possibility to ensure effective long term management for insurers.

The changes in the criteria proposed by EIOPA still fail to enhance the applicability of the asset class. The restrictions remain very strong. For instance, EIOPA seems to be relaxing the ring fencing requirement by deleting the term per se but yet leaving unchanged the rest of the wording, which depicts a ring fencing type of management.

The IRSG is also concerned at the impediment to qualify equities backing own funds as long term although this can be aligned with good risk management incentives. Own funds are a key factor of the balance sheet's resilience and instrumental in any long-term strategy. Long term management of own funds should be encouraged, subject to effective risk management. It is also often the case that insurer assets are managed within general portfolios backing all liabilities including own funds and any carve out is likely to be artificial.

With regards to criteria 1g, it is important to note that liquidity and solvency issues should not be confused. While we acknowledge the effective improvements EIOPA has brought forward for life undertakings, for non-life entities, EIOPA still requires insurers to cover all their best estimate liabilities with High-Quality Liquid Assets. This should have regard to the particular position of the undertaking and it is not necessarily the case that an insurer needs need to cover all its best estimate with liquid assets.

The IRSG makes the following additional comments on the proposed criteria:

- (1)(b): Remains unnecessarily restrictive.
- (1)(c): Further improvements are needed to ensure it is workable in practice
- (1)(e): Further improvements are needed to ensure it is workable in practice. IRSG proposes to substitute this criterion with a commitment-to-hold approach.
- (1)(f): The IRSG proposes an extension to OECD shares
- (1)(g): EIOPA's proposed extension of life liabilities to those in liquidity bucket I and II is welcome. However, the requirement for 10-year duration remains a significant barrier. It should be relaxed to reflect the lower durations of more typical life insurance portfolios.

We suggest also that Private Equity could be better acknowledged as a specific investment class as it is, by definition, a long commitment between the insurer and the target fund both in legal and in economic terms.

NON-PROPORTIONAL REINSURANCE

The IRSG welcomes EIOPA's work on the inclusion of enhanced recognition of Adverse Development Covers in the standard formula.

Any proposals to measure the effect of Non-Proportional Reinsurance (NPRI) should avoid introducing undue burden to the standard formula calculation. Given the absence of a better calibration solution from EIOPA, the approach which derives the net volatility for some lines of business by multiplying the gross risk factor by a flat rate should be maintained.

OWN FUNDS BUFFER FOR COMPRESSED SPREADS

The IRSG opposes the creation of an Own Funds buffer. EIOPA's rationale for such a type of capital add-on is unclear and the effectiveness of such a buffer remains questionable. EIOPA itself has highlighted a lot of the drawbacks of such an approach including double counting of risks, creation of an unlevel playing field, interaction with existing measures, complexity, etc.

TRANSITIONALS ON RISK-FREE INTEREST RATES AND ON TECHNICAL PROVISIONS

The IRSG supports Option 2: keep status quo. The changes proposed by EIOPA to its previous advice do not address the IRSG's concern about the creation of an unlevel playing field which were raised in its response to the consultation. The IRSG supports the continued application of transitional measures as foreseen by the SII Directive.

EXTRAPOLATION OF RISK-FREE INTEREST RATES

The IRSG strongly opposes EIOPA's proposed changes to the current extrapolation methodology and parameters used to derive the RFR curves. The current approach strikes a suitable balance between market consistent valuation, financial stability, risk management incentives and policyholder protection. In its latest advice, EIOPA has failed to provide any additional justification for the proposed changes. On the contrary, its impact assessments have demonstrated how severely detrimental they will be for a limited number of markets and providers of long-term insurance products within those markets.

The IRSG considers that EIOPA's updated analysis of the three criteria which determine the last liquid point continue to support the IRSG's view that the 20-year LLP should be retained for the Euro.

MATCHING ADJUSTMENT

EIOPA's analysis and proposals on the Matching Adjustment are welcomed by the IRSG.

RISK MARGIN

The IRSG welcomes EIOPA's proposal on the introduction of a lambda parameter into the Risk Margin calculation.

However, the IRSG and wider industry has raised concerns about the size and volatility of the risk margin on numerous occasions and it does not consider EIOPA's proposal to adequately address the issues that have been raised. It therefore recommends that EIOPA continues work in this area to further identify justified changes to Risk Margin including a reduction in the Cost of Capital and recognition of diversification as well as revisiting the proposed calibration of the Lambda factor.

PROPORTIONALITY

The IRSG welcomes the general approach proposed by EIOPA to improve the application of proportionality. It is important to work towards further convergence and consistency in the way proportionality is applied throughout EU Member States. Developing a harmonised and more predictable framework for proportionality is the vital end-goal. This will help EIOPA achieve a fair balance between predictability/consistency and the risk-based underlying principles of supervision. Bureaucratic processes in applying the proportionality principle must necessarily be avoided, as this would offset the benefits of proportionality.

At the same time, it is important for NCAs to keep some freedom and that supervisory dialogue is preserved. NCAs having the "final word" in the Supervisory Review Process (SRP) will provide some safeguards to allow a better application of proportionality while ensuring policyholder protection remains the priority. The IRSG notes that, in case of concern on the NCA side, a process of debate and conclusion would foster a better understanding of the risk profile and ensure that the NCA has the closest and most accurate view about a given undertaking.

Specific comments follow:

Low Risk Undertakings (LRUs)

More predictability in the way NCAs assess how an undertaking is considered as a LRU is welcomed. It is also a positive idea to reverse burden of proof, including requiring from NCAs explanations to undertakings when their LRU application is challenged. The LRU criteria (Paragraph #24) should focus on ensuring that the nature, scale and complexity of an undertaking are assessed altogether, i.e. defining a (re)insurance undertakings overall risk profile. Solvency II's overall objectives should be taken into account when assessing an undertaking's risk profile, and the related proportionality decision should be made holistically.

"In or out" thresholds should be avoided (as suggested in Para. #24) since this is more akin to an exemption approach rather than applying the principle of proportionality.

Cross border business is not appropriate to assess the risks of a particular undertaking. The risk inherent in an insurer's business model is not affected by cross-border operations per se. In fact, it can allow companies to benefit from risk diversification by operating in more than one market. This also undermines the objective of a CMU

Reinsurance business accepted is not appropriate factor for this assessment, as reinsurance does not yield high risks per se. There are reinsurance undertakings with very high solvency ratios that can be considered low risk undertakings.

An absolute size criterion is not risk based and not appropriate to assess the risks of a particular undertaking.

In any case, automatic application of proportionality measures should not be limited to low risk undertakings. This concept should be further developed to include low risk/non-significant activities in any company – on the model of EIOPA's supervisory statement on the "application of the proportionality principle in the supervision of the Solvency Capital Requirement".

Proportionality in Pillar 1

An approach that would allow LRUs to not implement a full stochastic valuation, but instead go only for a deterministic valuation if certain criteria are met, is welcomed. Setting a threshold for contracts with options and guarantees would be an appropriate approach to support this.

In respect of proportionality measures within Pillar 1, some other potential measures that could be explored further are:

o Applying reduced default capital charge on loans granted to policyholders where the loan is returned as and when claims are to be paid.

o Reliance on statutory reserves as a proxy for Best Estimates

o Considering the rating of the parent group when there is exposure towards several counterparties of the same group, rather than computing a weighted average of ratings.

o Setting non-life lapse risk to 0 when non-relevant / non-material (e.g. limited number of policies, captive undertakings, etc.).

o Reliance on "riskiest" Cresta zone per country for Nat Cat when assessing catastrophe risk if detailed data are not available.

Proportionality in Pillar 2

The IRSG welcomes the proposed changes in Pillar 2 (key functions, ORSA, written policies, administrative, AMSB, remuneration).

• The application of a biennial ORSA for LRUs while maintaining quarterly QRTs is welcome. However, it would make sense to allow LRU – without additional conditions – to conduct the ORSA only every 3 year, instead of once every 2 year. This would allow to align the frequency of the ORSA and the RSR and effectively reduce the burden on LRU. Moreover, the proposed "additional conditions" are not necessary and should be deleted. It could also be useful to explore the possibility of maintaining an annual ORSA without needing a full quarterly QRT for LRUs (since these quarterly QRTs for LRUs have very little variation and that the ORSA gives NCAs the perfect tool to identify changes in undertakings' risk profile anyway).

• There could also be merit in further consideration of improving application of proportional measures, considering a potential exemption for having an Internal Audit Function if the LRU has a

Risk Management Function, Actuarial Function or an External Audit Review. There is also room to explore proportionality measures around Governance and Functions more broadly.

Proportionality in Pillar 3

- The discussion around SFCR reporting could explore further the link between a risk-based approach and the policyholders' need for information. It is possible that a simple rule for exempting LRUs from public disclosure could be the presence of natural persons as insured (or PIE status). If this is the case, the SFCR is needed, otherwise the requirement to produce one could be waived in keeping with the principle of risk-based proportionality.

- In para. 67, the "operational way for monitoring" is inconsistent with a risk-based approach.

- The IRSG disagrees with the proposed change to Article 35 (option 2 in para 75–77), in particular reducing the threshold for limitations and exemptions from 20% to 5% market share due to an automatic exemption. When basing the exemption on risk-based criteria, there is no reason why any threshold should be set, even less a threshold lower than the current level. It would particularly affect markets where this measure is already broadly applied up to the current threshold.

- It is not appropriate that the proposed simplifications in pillar 3 are only granted to captives (para 88). Simplifications in reporting measures should be granted based on a risk assessment, which may include but should not be limited to the nature of the undertaking.

- The IRSG welcomes the proposal to require the RSR only every 3 years for low risk insurers.

- The IRSG is disappointed that changes to reporting are very limited, and do not include further proposals to simplify the SFCR and make it short enough and understandable for policyholders.

Captives

- Additional criteria to be met by captive reinsurance undertakings should not be added to the definition of captive undertakings from Article 13 (5) of the Solvency II Directive.

- More specifically, the following criteria from §124 should be removed:

    o "the maximum loss resulting from the exposure can be deterministically assessed without the use of stochastic methods".

Stochastic valuation is a more accurate method than the deterministic one and could represent a better fit for assessing the exposure of captive reinsurance undertakings according to their business risk profile.

• “Loans in place with the Parent or any group company do not exceed 20% of the total assets held by the captive, group cash-pools included”. This criterion has nothing to do with the business profile of a reinsurance captive and is already appropriately addressed in the SCR calculation.

• On SFCR, captive reinsurance undertakings should be exempted from producing a SFCR. These SFCRs for captive reinsurance undertakings do not add specific value to policyholders, improved security nor a better risk understanding. In addition, the presence of a fronting insurance undertaking (issuing insurance policies to the ultimate policyholders being legal entities of the group) make the need for such a disclosure irrelevant to policyholders, their contractual risk carrier being their fronting insurance company, regardless of the reinsurance contract existing between the said fronting company and the captive reinsurance undertaking.

Proportionality measures

• The IRSG welcomes the proposal that proportionality measures defined in the delegated regulation are considered a non-exhaustive list of possible measures.

• The IRSG disagrees with the assessment that proportionality measures should not lead to an exemption from some requirements. A complete exemption from a specific requirement should be allowed and may benefit policyholders where the requirement does not provide any added value for the supervision while producing costs for the affected company and tying up capacity of the responsible NCA.

• While the IRSG welcomes that EIOPA worked on a simplified approach for stochastic valuation, it is important that this new approach does not question present stochastic valuation approaches. In the absence of further details (how to estimate the TVOG from the PHRSS, calibration and generation of the PHRSS, interaction with the SCR calculation, e.g. LACTP…), a more thorough assessment of the proposal is not possible.

Reporting and monitoring of the application of proportionality

• The IRSG welcomes the proposal to replace the qualitative information on proportionality in the RSR by a QRT. This will allow to identify the areas where proportionality should be improved. However, the IRSG would like to stress that, to avoid offsetting the benefits of a reduced burden, the reporting on proportionality will have to be very simple and quick to fill.