	Comments Template on Discussion Paper on the review of specific items in the Solvency II Delegated Regulation	**Deadline 3 March 2017 23:59 CET**
Name of Company:	Lloyd's	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
	Please follow the following instructions for filling in the template: ⇨ Do **not** change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool ⇨ Leave the last column empty. ⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph or a cell, keep the row empty. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. **Please send the completed template, in Word Format, to CP-16-008@eiopa.europa.eu** **Our IT tool does not allow processing of any other formats.** The numbering of the questions refers to the discussion paper on the review of specific items in the Solvency II Delegated Regulation.	
Reference	**Comment**	
General Comment	This is a response on behalf of Lloyd's. Lloyd's is a society of members that operates as an insurance market in London. It is recognised in the Solvency II Directive as "the association of underwriters known as Lloyd's" and is subject to prudential regulation by the Prudential Regulation Authority (PRA). Lloyd's, like most of the UK insurance industry, is a firm supporter of the principles behind Solvency II, even if it has some reservations over the detailed implementation of the regime. The results of the 2016 referendum in the UK on EU membership mean that the UK is likely to leave the EU before the end of 2019. Nevertheless, Lloyd's interest in the Solvency II regime, and in this	

	review, will continue, because: • Lloyd's intends to make the necessary adjustments in order to continue to carry on EU insurance and reinsurance business after the UK has left the EU, so a portion of Lloyd's business will remain subjext to Solvency II. • It believes that, post-Brexit, the UK should retain an insurance regulatory regime that is aligned with Solvency II, to maximize possibilities of mutual market access and regulatory co-operation. The case for doing so is strengthened if Solvency II is an effective, efficient insurance regulatory regime, providing appropriate policyholder protection, whilst avoiding excessive prudence and unreasonable regulatory burdens. • Whatever the direction in which UK insurance regulation moves in the future, Solvency II is an prominent regulatory system, which will continue to influence regulatory developments worldwide. Under Solvency II, Lloyd's calculates its regulatory capital requirement using an internal model approved by the PRA. Lloyd's is nevertheless interested in the standard formula because the PRA requires firms using an internal model to report to them the results of a standard formula calculation annually. The PRA uses this to monitor model drift. Furthermore, the standard formula is at the heart of the Solvency II regime and is used by most EU insurance undertakings to calculate their regulatory capital requirements, so the credibility of the regime depends on perceptions of the standard formula as a plausible regulatory approach. Lloyd's believes that the Commission's original Solvency II objectives are still justifiable. These were that Solvency II should: • Improve consumer protection. • Modernise supervision. • Deepen market integration.	

	• Increase the international competitiveness of European insurers. The regime implemented in January 2016 goes a long way towards achieving these objectives. In the light of a year's experience of Solvency II's operation we believe that adjustments can be made to move Solvency II even closer to the original conception and to make Solvency II the world's leading insurance regulatory system.	
Q1.1		
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Q1.3	The geographical diversification factor in Article 116(2) is material to the calculation of the capital requirement for non-life premium and reserve risk for undertakings which carry on business internationally. For example, for Lloyd's, when using the standard formula, the non-life premium and reserve risk SCR is around £1.7bn (16%) higher if there is no geographical diversification credit. Solvency II is based on an economic approach to capital setting, which requires recognition of diversification. Recital 64 of the Solvency II Directive says: *"...the Solvency Capital Requirement should be determined as the economic capital to be held by insurance and reinsurance undertakings...That economic capital should be calculated on the basis of the true risk profile of those undertakings, taking account of the impact of possible risk-mitigation techniques, as well as diversification effects."* When insurance undertakings carry on business in different geographical regions, they avoid the concentration of risk that occurs if their activities are restricted to a single country. This reduces the amount of capital they require. The geographical diversification factor does not have a material impact on the capital requirement for undertakings whose business is restricted to one or a small number of countries. Many smaller or medium-sized EU insurance undertakings are in this position. They report premium and reserves for only one of the geographical regions set out in Annex III, so	

	geographical diversification does not represent a burden to them. Geographical diversification reduces the capital requirement for undertakings. Undertakings that do not want to claim this reduction can simplify the calculation by report all their numbers in a single region (they may do this if, for example, their exposures in other regions are immaterial) . This is in line with the principle of proportionality, as the higher levels of regulatory capital resulting do not represent an increased risk to the undertakings.	
Q1.4		
Q1.5	We question the inclusion of the non-life lapse risk sub-module in the Delegated Regulation and suggest that the standard formula could be simplified through its removal, since it adds unnecessary complexity for recognition of a non-material risk. For Lloyd's market-wide SCR calculated using the standard formula, the non-life lapse risk sub-module accounts for a capital charge of £400m: just 1.5% of its total market-wide SCR. Article 105(2) specifies the sub-modules for the non-life underwriting risk module. It does not mention a non-life lapse risk sub-module, so Article 118 of the Delegated Act is not in line with the Solvency II Directive. Furthermore, since most non-life insurance is arranged on one-year policies, the risk to non-life insurers from lapse risk is limited.	
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Q1.24	"Operational risk" is the risk of loss arising from inadequate or failed internal processes, personnel or systems or from external events (Solvency II Directive Article 13(33)). It is therefore a complex, heterogeneous category, particularly difficult to incorporate into a standard formula and to find a balance between simplicity and risk reflectiveness. The basic capital requirement for operational risk set out in Article 204 assumes that gross earned premiums are an appropriate exposure measure. It is reasonable to assume a link between operational risk and the size of an undertaking. Nevertheless, an undertaking's operational risk profile may be altered through the purchase of reinsurance: significant reinsurance purchase can limit the operational risk exposure of an undertaking (there is a commensurate rise in its capital charge for counterparty default risk under the standard formula: in line with Directive Article 107, the capital requirement for operational risk should not duplicate this). We therefore believe that net earned premiums are a better measure of operational risk and suggest that the calculation in Article 204 is amended accordingly.	
Q1.25		
Q1.26		

Q2.1	We believe that Article 4 is appropriate and do not have any improvements to suggest. It is a permissive provision, setting out the requirements for use of external credit assessments and is supplemented by Commission Implementing Regulation 2015/2015 on procedures for assessing external credit assessments. Undertakings should be able to use internal credit assessments as an alternative to external credit assessments. Nevertheless, this is not a plausible alternative for most insurers, as they require significant time and resources to obtain supervisory approval. Their widespread use would, in any case, introduce inconsistency in the treatment of similar risks in different firms.	
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Q6.1		
Q7.1	We agree with the proposal in EIOPA's 5 December, 2016 *Information request o the calibration of the natural catastrophe risk sub-module* that a joint working group with relevant stakeholders be created to update the natural catastrophe sub-module. As the Discussion Paper notes, this is one of the most important sub-modules in the standard formula, responsible for a significant proportion of the overall capital requirement for non-life insurers. Before applying an allowance for diversification, it constitutes 36% of Lloyd's market-wide SCR. Although unnecessary complexity should be avoided, it needs to be sufficiently granular to ensure that an undertaking's capital requirement is appropriate for the risks that they are undertaking. At the same time, it is important not to exaggerate the granularity of the sub-module. The Paper says that it includes 27 regions for Europe and 17 for the rest of the world. In fact, the number of regions for Europe varies, depending on the peril: there are no more than 20 regions (essentially countries) for any particular peril. For the rest of the world, there are 14 regions. The rest of the world regions are relevant to the calculation of geographical diversification only.	

	It is appropriate to consider the effect of high granularity on smaller undertakings. Smaller undertakings generally carry on business in restricted geographical areas, limiting the impact of granularity on them. Probably few smaller EU undertakings carry on business outside the EU, so they do not include non-European exposures in their calculations. The level of granularity for the rest of the world does not affect them. On the other hand, geographical diversification is important to undertakings that carry on business internationally and the sub-module should not be amended to reduce the effect of geographical diversification. Any reductions or removal of geographical diversification would increase the capital requirements of EU insurance and reinsurance undertakings carrying on business internationally, affecting their competitiveness in global markets.	
Q7.2	The proposed EIOPA expert group should look at the question of simplifications, using the data reported in the annual templates for 2016. In appropriate cases it could suggest groupings of zones where the risk is very similar, thereby simplifying the standard formula calculation in the Delegated Regulation. This should be done through dialogue with undertakings whose capital requirements may be affected, to avoid any unintended consequences. Even without changes to the Delegated Regulation, the principle of proportionality should mean that undertakings can calculate a capital requirement at the level of a region without further division into zones. A simplification such as this should be optional, allowing undertakings to continue to apply a more granular, risk-based approach should they wish.	
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Q8.8	We agree that it would be more accurate to base scenarios for marine, aviation and fire risks on the net sums insured rather than gross, to allow the largest net exposure rather than the largest gross exposure to be selected.	
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Q12.4	The calculation is disproportionately complicated. There is significant granularity and a number of inputs are required for a risk module whcih makes only a small contribution to the overall SCR of most insurers (including Lloyd's).	

	The high level of granularity does not enhance the CPD calculation, particularly given the time taken to complete the requred fields for each counterparty and the possibility of errors due to the number of inputs. A single Lloyd's syndicate may have more than 500 named exposures. Calculating counterparty default risk entails completing 18 fields per counterparty. There are 84 syndicates at Lloyd's in 2017, so across the Lloyd's market the task is extremely time-consuming.	
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Q15.1	First of all, we note that Solvency II's approach to currency risk is not only a problem for groups: the approach is the same for groups and for solo entities, so affects groups and solo undertakings in the same way. The advice provided to the Commission should therefore relate both to groups and solo undertakings. EIOPA has not felt constrained to respond only on the points specifically mentioned in the Commission's request for advice, so it should consider the impact of the standard formula's currency risk sub-module on solo undertakings as well as groups. The European Commission's Call for Advice asked EIOPA to „*investigate if the approach taken to group currency risk adequately covers the risk to which the group is exposed, taking into account the incentives given to the group's risk management...*" We are concerned that the questions that stakeholders are asked will not allow EIOPA to provide appropriate advice to the Commission on this point, particularly in relation to the incentives given to a group's risk management. We also believe that any consideration of Solvency II's approach to currency risk which ignores the impact on solo entities is incomplete. FX translation risk can impact levels of surplus at group/overall undertaking level, but it cannot threaten the overall solvency of the undertaking. We agree that the market risk module should include a currency risk sub-module, but this must be designed so that it is in line with Solvency II's fundamental principles: it should be risk-based, protect policyholders and promote good risk management. The main objective of supervision is the protection of policyholders and beneficiaries[1] and FX translation risk does not affect an undertaking's ability to meet the reasonable expectations of policyholders and beneficiaries, whether it is in a group or is a solo undertaking. A group may have subsidiaries in jurisdictions other than that in which the group head office is	

[1] Solvency II Directive Article 27

	established. If a subsidiary uses a different currency from that used for the preparation of the consolidated accounts, changes in exchange rates will have an impact on the group accounts. However, this will not affect the ability of the group to meet its obligations: its solvency position is the same, since the changes affect both sides of the balance sheet in the same way. The most significant risk associated with currency arises from mismatching: when an undertaking holds assets in a different currency from that of its liabilities. In these circumstances, fluctuating exchange rates can affect its ability to meet liabilities. If a solo undertaking holds its assets and liabilities in the same currency, changes in exchange rates can never threaten its solvency, because a reduction in the local currency value of a foreign currency reduces the local currency value of foreign currency assets, liabilities and capital requirements equally. Good currency risk management therefore entails holding excess assets over liabilities in a mix of currencies with regard to the possible outcomes the capital is covering. A prudent approach to currency risk in Solvency II would incentivise undertakings to hold assets in foreign currency in proportion to its foreign currency liabilities, thereby holding prudent buffers against foreign currency risks. A total balance sheet approach requires all risks and their interactions to be considered. The lack of interaction between risks is a fundamental flaw in the standard formula's current approach to currency risk. In essence, the Solvency II SCR requires enough Own Funds at time 0 to ensure a Solvency II balance sheet can be adequately formed in one year's time with a confidence of 99.5%, after a series of unexpected events have occurred. Currency risk is one of those events. The current approach assumes that currency shocks occur on the opening balance sheet and therefore misses the interaction between currency risk and other risks over the one year period. The total balance sheet approach means that the currency risk sub-module must apply to assets held by an undertaking in excess of its regulatory capital. Of course, logically it is perverse that an insurer can incur additional regulatory capital charges by holding such excess assets, as they	

	reduce risk rather than increasing it, but this is an inevitable consequence of the total balance sheet approach.	
Q15.2	The fundamental position should be that an undertaking's capital and the assets backing its technical provisions are available to meet any policyholder claims. Assets held in foreign currency are assets of the entire business. Their availability is not restricted to the support of foreign currency transactions. No useful regulatory purpose would be served by treating them as ring-fenced funds. This general principle does not affect application of Directive Article 99 and Article 80 of the Delegated Regulation, whereby own-fund items which meet certain criteria are treated as ring-fenced funds. The current standard formula approach to currency risk encourages an undertaking or group to hold all its excess assets in local currency to reduce its currency risk capital charge. This approach effectively assumes that any shock/stresses on liabilities will occur in the local currency only, which makes no sense when an undertaking is exposed to foreign currencies. It means that a group is less able to offset adverse outcomes in one business with favourable outcomes in another, since its ability to do so can be affected by exchange rate movements. On the other hand, an approach based on matching currency with liabiliites takes account of the undertaking's currency risk profile and does not assume that currency risk is zero when an undertaking has foreign currency liabilities but is holding all its excess assets in local currency. If an undertaking is matching foreign currency risk exposures with foreign currency assets by holding a portion of its excess assets in foreign currency it is better able to respond to shocks in foreign currency. Hence a group or undertaking is better able to offset averse outcomes in one area of the business with favourable outcomes in another.	
Q15.3	We believe that own funds across the group and across a solo entity are fungible, with the exception of certain funds to which restrictions apply.	

	If a group or solo entity transacts business in a foreign currency, a stress situation for that currency will not affect its ability to meet policyholder claims, providing it has prudential currency risk management processes in place. If it is holding foreign currency assets in proportion to its foreign currency liabilities, the rise or fall in the value of assets and liabilities will match. A major problem with the existing Solvency II approach to currency risk is that it encourages groups and undertakings to hold excess assets in the local currency, even when it has substantial foreign currency liabilities.	
Q15.4	We do not consider the treatment of currency risk in the standard formula to be appropriate for groups or solo undertakings. • It does not reflect real currency risks faced by insurers. • It incentivises poor currency risk management. • It reduces the international competitiveness of EU insurers. The currency risk sub-module essentially requires an undertaking to apply a capital charge of 25% to its net asset value (assets less booked liabilities) for a foreign currency (any currency other than that used to prepare its financial statements). This penalises insurers who hold excess assets in foreign currencies, even though so doing is the most prudent approach for those carrying on business in foreign currencies. Firms who hold excess assets in their local currency do not incur a capital charge, even though they thereby increase their exposure to currency risk. Firms that face currency risk will actively manage their currency exposures, holding foreign currency assets not only to match expected outcomes but also to cover possible deteriorations. Most international supervisors expect firms to manage and mitigate their currency risks. Insurance Europe has previously put forward proposals to amnd the currency risk sub-module, for consideration by the European Commission and EIOPA. We support their approach. In its latest	

iteration it was as follows :

Delegated Regulation Article 188

3. The capital requirement for the risk of an increase in the value of the foreign currency against the local currency shall be equal to the loss in the Currency Risk Exposure (CRE) in the local currency that would result from the instantaneous increase of 25% in the value of of the foreign currency against the local currency, where CRE is defined for each foreign currency c, as the difference between :

- Actual assets held in currency c ; and

- The required assets in currency c

Where « required assets » are defined as the sum of the booked liabilities in that currency plus the proportion of the overall net asset value allocated to that currency.

The neet asset value is allocated to currencies in proportion to the split of liabilities by currency, unless there is information to the contrary.

This applies to all the assets and liabilities of the undertaking but should take account of currency hedging instruments.

[Sub-article 4 follows the same approach]

As an alternative, we believe that the approach to currency risk in the IAIS's 2016 Technical Specifications for field testing in relation to the Insurance Capital Standard is preferable to the standard formula approach, because :

- It gives credit (10% of liabilities) for a movement in a currency with excess assets.
- It has two scenarios : increase of long/short currencies and then applies the most severe one of these (similar to SF interest rate risk).
- The level of stress varies by currency and 50% correlation is applied between currency

	movements.	
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Q19.1	The Risk Margin is widely viewed as one of the least satisfactory features of Solvency II. Even before Solvency II's implementation it was recognised that it was over-sensitive to risk-free rates and that its volatility was undesirable from a microprudential and macroprudential point of view (see speech by Sam Woods, PRA CEO, 3 November, 2015). The Bank of England's Financial Policy Committee's Financial Stability Report, published November 2016 looked at risks to financial stability from insurers' investment behaviour. One of its conclusions was that « *limiting the sensitivity of the risk margin to changes in risk-free interest rates would have macroprudential benefits* ».	

	The low interest rate environment makes the Risk Margin particularly problematic, particularly for life insurers. Because the Lloyd's market does not carry on life insurance (other than a small amount of term life insurance) the Risk Margin is not a major concern for us. Nevertheless, we support calls for its re-evaluation, since problems with the Risk Margin are sufficiently serious to discredit the whole Solvency II regime. Determination of the Cost-of-Capital rate as 6% by CEIOPS back in 2009 was a highly theoretical exercise. Irrespective of whether the methods and assumptions for the calculation are still appropriate, practical experience of the application of the rate in the real world suggests that it is excessively prudent, to the detriment of the EU's insurance industry. EU insurers' extensive reinsurance of longevity risk with non-EU reinsurers, whose capital requirements are lower, is a clear signal that the Risk Margin is not working as planned. We therefore support calls for the re-asessment of the Risk Margin in the light of experience.	
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