EIOPA-BoS-14/172

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Final Report

on

Public Consultation No. 14/036 on

Guidelines on basis risk

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1. Executive summary

Introduction

According to Article 16 of Regulation (EU) No 1094/2010 (EIOPA Regulation) EIOPA may issue guidelines addressed to National Competent Authorities (NCAs) or financial institutions.

According to Article 16 of the EIOPA Regulation, EIOPA shall, where appropriate, conduct open public consultations and analyse the potential costs and benefits. In addition, EIOPA shall request the opinion of the Insurance and Reinsurance Stakeholder Group (IRSG) referred to in Article 37 of the EIOPA Regulation.

According to Article 210 of the Implementing Measures[1] risk-mitigation contracts shall not result in material basis risk or in the creation of other risks, unless this is reflected in the calculation of the Solvency Capital requirement. Article 86 of the Implementing Measures sets out a method to reflect material basis risk resulting from a currency mismatch between underwriting risk and the risk-mitigation technique. EIOPA has developed Guidelines to facilitate convergence of practice across Member States and to support undertakings in identifying material basis risk.

As a result of the above, on 2 June 2014 EIOPA launched a Public Consultation on the draft guidelines on the basis risk. The Consultation Paper is also published on EIOPA's website[2].

These guidelines were issued to undertakings and NCAs to:

- Establish consistent, efficient and effective supervisory practices;
- Ensure the common, uniform and consistent application of Union law on the assessment of material basis risk and the subsequent recognition of risk mitigation techniques in the calculation of the Solvency Capital Requirement with the standard formula.

Content

This Final Report includes the feedback statement to the consultation paper (EIOPA-CP-14/036) and the Guidelines. The Impact Assessment and cost and benefit analysis, and the Resolution of comments are published on EIOPA's website[3].

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[1] As published by the European Commission on 10 October 2014: http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/delegated/141010-delegated-act-solvency-2_en.pdf

[2] [3] https://eiopa.europa.eu/consultations/consultation-papers/2014-closed-consultations/june-2014/public-consultation-on-the-set-1-of-the-solvency-ii-guidelines/index.html

Next steps

In accordance with Article 16 of the EIOPA Regulation, within 2 months of the issuance of these guidelines, each competent authority shall confirm if it complies or intends to comply with these guidelines. In the event that a competent authority does not comply or does not intend to comply, it shall inform EIOPA, stating the reasons for non-compliance.

EIOPA will publish the fact that a competent authority does not comply or does not intend to comply with these guidelines. The reasons for non-compliance may also be decided on a case-by-case basis to be published by EIOPA. The competent authority will receive advanced notice of such publication.

EIOPA will, in its annual report, inform the European Parliament, the Council and the European Commission of the guidelines issued, stating which competent authority has not complied with them, and outlining how EIOPA intends to ensure that concerned competent authorities follow its guidelines in the future.

2. Feedback statement

Introduction

EIOPA would like to thank the Insurance and Reinsurance Stakeholder Group (IRSG) and all the participants to the Public Consultation for their comments on the draft Guidelines. The responses received have provided important guidance to EIOPA in preparing a final version of these Guidelines. All of the comments made were given careful consideration by EIOPA. A summary of the main comments received and EIOPA's response to them can be found in the sections below. The full list of all the comments provided and EIOPA's responses to them is published on EIOPA's website.

General comments

1. Partial risk mitigation

a) Concerns were raised that the Guidelines do not allow for partial risk reductions resulting in a partially reduced capital requirement. The criterion "the exposure covered by the risk-mitigation technique is sufficiently similar in nature to the risk exposure of the undertaking" in Guideline 1 was interpreted as suggesting that the only acceptable risk mitigation techniques are the ones where the underlying exposures are almost identical to the exposure they are supposed to mitigate.

b) EIOPA is aware that the Solvency II framework allows for partial risk reductions (e.g. if protection is bought for a drop in equities up to a certain percentage). But according to the Implementing Measures risk mitigation techniques (resulting in full or partial risk reduction) with material basis cannot be recognised in case the method set out in Article 86 DA is not applicable. The Guidelines provide guidance how to determine whether material basis risk exists. Whether an exposure is sufficiently similar in nature will have to be assessed for each individual case. An interest rate derivative will for instance in general not provide a good hedge for equity risk.

2. Sufficient instead of necessary conditions for the absence of basis risk

a) It was suggested that the conditions (a) und (b) in Guideline 1 should be sufficient to consider the basis risk of a risk mitigation technique as not material. This would contribute to a consistent application.

b) EIOPA agrees and has changed the Guideline accordingly.

3. Inclusion of 1/200 year events in the comprehensive set of risk scenarios

a) It was suggested to include in the comprehensive set of risk scenarios also suitably extreme (i.e. 1/200 year) events.

b) EIOPA agrees and has changed the Guideline accordingly.

4. Cap on the maximum loss protection

a) According to Guideline 2 the basis risk for a contract that mitigates spread risk with a cap on the maximum loss protection as a proportion of the principal amount should only be assessed for the proportion covered by the contract. It was suggested that this requirement should also apply to other market risks as well as counterparty risk.

b) EIOPA agrees and has extended the scope of the Guideline to other risks.

General nature of the participants to the Public Consultation

EIOPA received comments from five stakeholders to the public consultation. All the comments received have been published on EIOPA's website.

Respondents can be classified into three main categories: European trade, insurance, or actuarial associations; national insurance or actuarial associations; and (re)insurance groups or undertakings.

IRSG opinion

The IRSG opinion on the draft set 1 of the Solvency II Guidelines on Pillar 1 and Internal Models, as well as the particular comments on the Guidelines at hand, can be consulted on EIOPA's website[4].

Comments on the Impact Assessment

A separate Consultation Paper was prepared covering the Impact Assessment for the Set 1 of EIOPA Solvency II Guidelines. Where the need for reviewing the Impact Assessment has arisen following comments on the Guidelines, the Impact Assessment Report has been revised accordingly.

The revised Impact Assessment on the Set 1 of EIOPA Solvency II Guidelines can be consulted on EIOPA's website.

[4] https://eiopa.europa.eu/about-eiopa/organisation/stakeholder-groups/sgs-opinion-feedback/index.html

Annex: Guidelines

1. Guidelines on basis risk

Introduction

1.1. According to Article 16 of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (hereinafter "EIOPA Regulation")[5] EIOPA is drafting Guidelines on basis risk.

1.2. The Guidelines relate to Article 104 and 105 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (hereinafter "Solvency II")[6].

1.3. These Guidelines are addressed to supervisory authorities under Solvency II.

1.4. These Guidelines are aimed at facilitating convergence of practice across Member States and at supporting undertakings in calculating their capital requirement for market risk under Solvency II.

1.5. These Guidelines concern undertakings and professionals responsible for the treatment of the risk mitigation techniques in the calculation of the Solvency Capital Requirement with the standard formula.

1.6. The aim is to increase consistency and convergence of professional practice relating to the treatment of risk mitigation techniques in the calculation of the Solvency Capital Requirement for all types and sizes of undertakings.

1.7. If not defined in these Guidelines the terms have the meaning defined in the legal acts referred to in the introduction.

1.8. These Guidelines shall apply from 1 April 2015.

Guideline 1 – Risk-mitigation techniques with no material basis risk

1.9. Undertakings should consider that a risk-mitigation technique does not result in material basis risk where the following conditions are met:

(a) the exposure covered by the risk-mitigation technique is sufficiently similar in nature to the risk exposure of the undertaking;

(b) the changes in value of the exposure covered by the risk-mitigation technique closely mirror the changes in value of the risk exposure of the undertaking under a comprehensive set of risk scenarios, including scenarios that are consistent with the confidence level set out in Article 101(3) of Solvency II.

[5] OJ L 331, 15.12.2010, p. 48–83
[6] OJ L 335, 17.12.2009, p. 1-155

Guideline 2 - Financial risk-mitigation techniques: assessment criteria of material basis risk

1.10. Before allowing for financial risk-mitigation techniques in the calculation of the Solvency Capital Requirement with the standard formula, undertakings should assess inter alia:

(a) the materiality of the basis risk with reference to the exposure covered by the risk-mitigation technique and the risk exposure of the undertaking without considering other balance sheet items, unless there is a continuous and consistent connection between other balance sheet items and the risk exposure of the undertaking;

(b) the similarity of the nature of the exposures referred to in Guideline 1 by taking into account at least the type and terms and conditions of the instruments or arrangements involved and the rules governing the markets where their prices are quoted or which provide the data for their valuation;

(c) the changes in the value of the exposures under a comprehensive set of risk scenarios referred to in Guideline 1 including all scenarios considered in the relevant modules or sub-modules of the standard formula by at least taking into account:

(i) the degree of symmetry among both exposures;

(ii) any non-linear dependencies under the scenario;

(iii) any relevant asymmetry of the behaviours in case of risk sub-modules where both upward and downward stresses are applied;

(iv) the levels of diversification of each respective exposure;

(v) any relevant risks not captured explicitly in the standard formula;

(vi) the whole distribution of pay-outs applying to the risk-mitigation technique.

1.11. The risk-mitigation technique should be considered to result in material basis risk where the above assessment does not provide sufficient evidence that the changes in value of the exposure covered by the risk-mitigation technique mirrors all material changes in value of the risk exposure of the undertaking.

1.12. Where the terms and conditions of a risk-mitigation technique specify a cap on the maximum loss protection as a proportion of the initial exposure, undertakings should apply the assessment only to the proportion covered by the risk-mitigation technique when determining whether the basis risk is material.

Guideline 3 - Insurance risk-mitigation techniques with no material basis risk

1.13. Before allowing for an insurance risk-mitigation technique in the calculation of the Solvency Capital Requirement with the standard formula, undertakings should identify whether reinsurance or special purpose vehicle arrangements behave differently than the insurance policies of the undertaking under a comprehensive set of risk scenarios due to differences in terms and conditions.

1.14. Undertakings should consider basis risk arising from a currency mismatch to be material where the exposure covered by the insurance risk-mitigation technique is denominated in a different currency than the risk exposure of the undertaking, unless the currencies involved are pegged within a sufficiently narrow corridor or the fixed exchange rate is provided in the reinsurance contract.

1.15. If there is material basis risk stemming from a currency mismatch as referred to in paragraph 1.14, undertakings should not allow for the risk-mitigation technique in the calculation of the Solvency Capital Requirement unless the provisions of Article 86 of the Implementing Measures apply.

Compliance and Reporting Rules

1.16. This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, Competent Authorities and financial institutions shall make every effort to comply with guidelines and recommendations.

1.17. Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.

1.18. Competent authorities shall confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.

1.19. In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

Final Provision on Reviews

1.20. The present Guidelines shall be subject to a review by EIOPA.

2. Explanatory text

Guideline 1 – Risk-mitigation techniques with no material basis risk

Undertakings should consider that a risk-mitigation technique does not result in material basis risk where the following conditions are met:

(a) the exposure covered by the risk-mitigation technique is sufficiently similar in nature to the risk exposure of the undertaking;

(b) the changes in value of the exposure covered by the risk-mitigation technique closely mirror the changes in value of the risk exposure of the undertaking under a comprehensive set of risk scenarios, including scenarios that are consistent with the confidence level set out in Article 101(3) of Solvency II.

2.1. A possible case of a risk-mitigation technique with no material basis risk is the situation where the change in value of the exposure covered by the risk-mitigation technique would mirror at least 90 per cent of the change in value of the risk exposure of the insurance or reinsurance undertaking and the resulting deviation of 10% would not lead to a misstatement of the risk-mitigating effect on the overall Solvency Capital Requirement.