Implementing Technical Standards re Approval Processes – Discussion by Pillar 1 working sub-group

EIOPA IRSG – 29 April 2014

Aims for today

- Expose initial thinking from consideration of the draft ITS
- Offer provisional thoughts on what should be addressed by the formal IRSG opinion to be submitted in June
- Stimulate IRSG consideration and discussion of whether or how draft ITS might be improved on the interests of all stakeholders
- Elicit views from stakeholder group on points to be included in IRSG opinion, particularly supporting arguments for recommended improvements

This is the only opportunity for all IRSG members to contribute to draft opinion on ITS

Discussion agenda

- General observations on draft ITS
- Matching adjustment – Maria Aránzazu
- Internal Models – Edgar Koning / Dieter Wemmer
- Undertaking Specific Parameters – Seamus Creedon
- Ancillary Own Funds – Yannick Bonnet
- Special Purpose Vehicles – Jari Eklund / Edgar Koning
- IRSG input and next steps

General observations

- We recognise that implementing technical standards are required in relation to approval processes in order to assure consistent and reliable implementation of Solvency II in the interests of stakeholders generally.
- We do expect a natural variety in the numbers and types of insurers which will appropriately wish to seek approval for

  Use of matching adjustment
  Undertaking specific parameters
  Ancillary own funds

  in the interests of their own stakeholders.

General observations – business as usual

- Use of a matching adjustment is established actuarial practice in pricing and management of non-par guaranteed products in several markets;
- Undertaking specific parameters – on the initiative either of the undertaking or the supervisor – are essential to control of more specialised insurance undertakings;
- Ancillary own funds contribute to sustaining financial stability in volatile markets, particularly for the mutual sector

General observations – themes for improvement

- ITS should not be excessively bureaucratic or complex, particularly where large numbers of undertakings are likely to be seeking approval – strengthen emphasis on proportionality;
- Approval should as far as practical be timely – in the interest of stakeholders. Where large numbers of smaller insurers are involved, processes should be streamlined.
- Silence should not necessarily be interpreted negatively, particularly in relation to matters which have historically been part of the routine of actuarial business management.

Discussion – Implementing Technical Standards for Approval of Application of a Matching Adjustment

- Maria Aránzazu

Products to which the matching adjustment applies

- Annuities and other long-term life insurance savings and pension/retirement products
  - Pure life annuities
  - Life annuities that also include mortality guarantees
  - Long-term lump sum products
- Assigned portfolio of assets providing fixed and certain cash flows to match the insurance liability cash flows (asset-liability management)
- Due to the specific characteristics of the liabilities and the assigned portfolio of assets, the insurance undertaking is not exposed to short-term volatility of spreads, because the assets will be held-to-maturity and there is no risk of forced sale of the assigned portfolio of assets
- All these features enable consumers to benefit from guaranteed interest rate products with the extra returns that are typically available on long term assets (as compared with the returns available on short term assets)
- The matching adjustment will allow the preservation of the offering of life insurance products with long-term guarantees and, consequently, the maintenance of the role of the insurance sector as an institutional investor, providing long-term financing to the European economy

Potential negative consequences of the draft ITS with respect to existing business

- Article 20.1.B.(a)(ii) of Life Directive 2002/83/EC allows insurance undertakings to fully recognize the effects of long term asset-liability management (ALM) strategies in valuing their insurance liabilities and the corresponding assigned assets backing them

- Therefore, there are countries where life insurance undertakings already apply a measure very similar to the matching adjustment. The starting point is not the same in all EU jurisdictions

- For these countries the procedures of the Draft ITS would lead to the supervisor receiving and having to assess a very large number of applications in respect of many existing portfolios of insurance obligations, with only nine months in which to do so, from 1 April 2015 to 31 December 2015

- The proportionality principle has to be interpreted taking into account the effects that an ITS such as this may have both on the insurance undertakings and on the supervisors in the various EU jurisdictions, and solutions need to be found to ensure that this principle is not breached in any of them as a result of differences among the respective markets

Potential negative consequences of the draft ITS with respect to new business

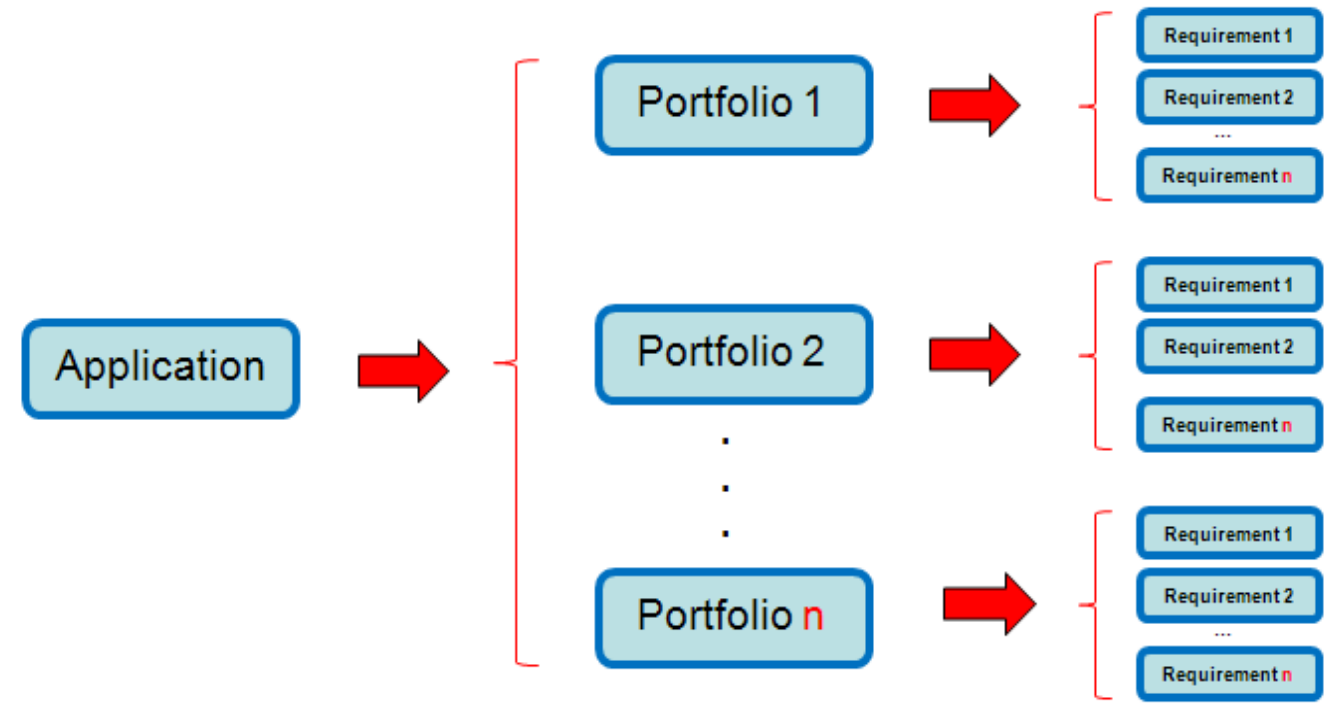
- For new business, the 6 month consideration period could constitute a serious obstacle to offering new products with long-term guarantees
- An insurance undertaking intending to sell a product to which it wishes to apply the matching adjustment cannot wait for 6 months or even more to be able to do so. Product design and launching and investment decisions take place in much shorter timeframes
- The strategic or policy decision underlying the package of LTG measures, and in particular the matching adjustment, is to ensure the maintenance of the supply of insurance products with long-term guarantees, not only as regards the past (existing business) but also for the future (new business)
- The formal requirements set forth in the ITS, and especially the 6-month consideration period, should not constitute an obstacle for the insurance sector to still provide long-term guarantees to the benefit of consumers. Otherwise it would be extremely detrimental both for consumers and for the long-term financing of the European economy

Possible solutions - 1

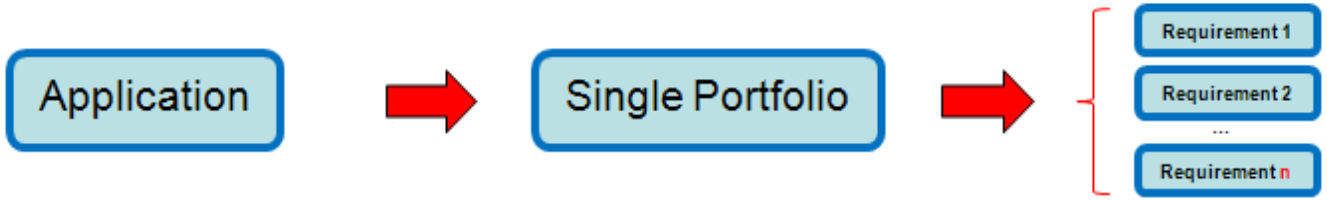
- **Consider all products to which the matching adjustment is applied as a single portfolio of insurance obligations (see Figure in next page)**

- Article 77ter(1)(b) of the Directive considers all the products to which the matching adjustment is to be applied as a single portfolio of insurance obligations, and all the assets assigned to it as a single portfolio of assets
- This would make it possible to lighten the huge administrative workload which otherwise would burden markets that have been applying a measure very similar to the matching adjustment for many years
- Additionally, if an insurance undertaking has already received approval to apply the matching adjustment, it should be possible for that insurance undertaking to re-use the same application or refer to it when requesting approval for a new product with similar characteristics in the future

DRAFT ITS



PROPOSED SOLUTION



Possible solutions (contd)

2. **The consideration/approval period should be shortened to a maximum of 3 months (instead of 6 months)**

- The consideration/approval period should be capped at a maximum of 3 months, as in the case of the draft ITS on the assessment of the application of ancillary own-fund items

3. **Simplify the content of the application / Allow supervisors to require evidence, as the case may be, only of those requirements of the matching adjustment that have not been previously assessed**

- A simplification of the requirements for quantitative and qualitative evidence accompanying the application is needed in terms of proportionality and operational practicality
- The draft ITS should allow the supervisors to require evidence, as the case may be, only of the requirements of the matching adjustment that differ from those in the current local legislation, and not of the requirements that have been previously assessed by the supervisor

4. **Leave to usual local practice the interpretation of silence of Supervisory Authority**

- Administrative law is not harmonised at EU level. In some EU jurisdictions the usual local practice is taking silence after the consideration period as acceptance. Therefore usual local practice should prevail

Discussion – Implementing Technical Standards for Approval of Internal models

- Edgar Koning / Dieter Wemmer

General remarks – internal model approval (1/2)

- The CP has a process focus, which is justified by the already highly detailed nature of Level 1 and Level 2.
- The CP contributes to the objective of harmonization and consistency through laying down the ground rules for an approval process applicable in al MS.
- Some elements do create some uncertainty, as supervisory authorities are granted a certain level of discretion in their decision-making process (e.g. as signaled by the terms '*recommendations*', '*adjustments*', '*terms and conditions*' etc.). We acknowledge it may be impossible to define hard and fast rules which would apply for all conceivable applications, however, clearer guidance would be advisable and beneficial to both undertakings as well as supervisory authorities.

General remarks – internal model approval (2/2)

- Question: The CP seems to deal with approval of internal models for solo purposes – will there be a separate ITS on approval of group internal models?
  - If not the specific issues relating to an application for using a group internal model should be included. The guidance should require the relevant supervisors to agree on the key components of the IM application and related interpretation of requirements (e. g. whether valuation methodologies are part of the IMAP or not). If no agreement can be reached, the issue should be directly addressed to EIOPA to ensure EU wide consistent interpretation.

Specific remarks – internal model approval (1/2)

- Preamble, consideration (6):
  - *"During the approval process supervisory authorities should be able to give recommendations on the need of adjustments to the internal model or for a transitional plan […]"* – The term 'recommendation' is not defined within the scope of the ITS, resulting in uncertainty as to the nature, scope, and required response to recommendations.
  - In general the possibility for supervisors to require adjustments is seen positive as the previous binary decision on model approval is softened. On the flipside this also means that the approval process might require more documentation and model adjustments therefore also taking more time (a corresponding suspension of the approval period is possible, c.f. Art. 4(9)).
- Article 2 (3) (p):

  "[…] an estimation of the Solvency Capital Requirement at the most granular level according to the insurance or reinsurance undertaking risk categorization, calculated with the internal model and with the standard formula for the last point in time […]" – It may be questioned whether the provision of such SCR data at the most granular level would actually be beneficial to the decision-making process.

Specific remarks – internal model approval (2/2)

- Article 4 (7) and (8):

  "[…] adjustments to the internal model […]" – Preferably there would be some additional language on what basis adjustments can or may be requested, in order to ensure harmonization and consistency.

- Article 7 (2):

  "The transitional plan shall be approved by the administrative, management or supervisory body […]" – Given the technical nature of transitional plans required by supervisors to extend the scope of partial internal models it should be sufficient to have the transitional plan approved by appropriate Risk Committees rather than administrative, management or supervisory body.

Discussion – Implementing Technical Standards for Reaching a Joint Decisions re Group Internal Models

- Edgar Koning / Dieter Wemmer

General remarks – joint decision internal models (1/2)

- The CP provides a balanced framework for the process to be implemented by supervisory authorities to reach a sound and joint decision for group internal models.
- Requirements with respect to positions, decisions and communications are clear and should be welcomed by all stakeholders.
- The referral to EIOPA (e.g. in such cases a decision is not likely to be reached between the supervisors involved) may prove to be a strong driver of harmonization and consistency within and among MS.
    - Question: Has EIOPA considered to include this approach in other ITS?

General remarks – joint decision internal models (2/2)

- Perhaps not within the scope of this CP, but a relevant subject nonetheless, is whether or not other stakeholders (such as undertakings) are enabled to challenge supervisors' positions and decisions. If yes, how does EIOPA envisage such a process would take place? This is especially relevant as it is quite likely stakeholders would challenge the positions and decisions of the specific supervisory authority in their respective MS.

Specific remarks – joint decision internal model

- Article 3 (2) and (4):

  "The supervisory authorities concerned shall take into account […] any legal impediments or internal processes that may restrict the supervisory authorities to give their formal view on the application within the specified timeframe.". "[…] when consensus on a decision is not likely to be reached, [the supervisory authority] shall explain the reasons for this to the other supervisory authorities concerned and indicate whether it intends to refer the matter to EIOPA[…]. The group supervisor shall organize a discussion with all supervisory authorities concerned with the aim to find a solution to the matter. […]" – While no authorization is given to group supervisors to enforce common timelines or process for the approval it would help the process of finding a common position to include **stronger language requesting supervisors to proactively cooperate in finding an agreement fully exploring the space within any legal constraints before the matter is referred to EIOPA.**

- Article 4 (3):

  "The group supervisor, […] shall draft a written proposal for a decision, including, if applicable, the terms and conditions which the proposed decision is subject to. […]" – We see the introduction of terms and conditions mainly positive as it softens the previous digital decision on model approval – however the flipside is that this might result effectively in a multi-year recurring approval process (as each of the conditions would supposedly require a subsequent model change which would trigger a new approval process in the following years).

Discussion – Implementing Technical Standards for Approval of Undertaking-Specific Parameters (USPs)

- Seamus Creedon

Provisional IRSG view – for discussion

- The need for a broadly consistent approach by supervisors justifies the need for an implementing technical standard in relation to applications for approval of USPs.
- Consumers and stakeholders will be best served if the standard includes more on the rationale for making the application and allows more discretion with respect to data and method.

Simplicity, comparability and risk sensitivity

- The tension between these three desirable attributes of regulatory frameworks is the subject of active debate in the context of Basel III and of IAIS BCR development.
- These objectives are also in tension in the context of Solvency II and the framework can be said to address them unevenly.
- The underlying challenge is how to reflect the heterogeneity of the real world in what is intended to be a harmonised framework

Heterogeneity in the air..

- Insuring A380s and helicopters both are aviation insurance
- Claim frequency/severity are however very different
- An averaged standard formula SCR calibration may lead to higher prices for helicopter insurance and to insolvency for an A380 insurer (if undertakings specialise)

..and on the ground in European insurance

- A sceptical attitude to undertaking specificity is justified in many cases:
  - Larger diversified firms unlikely to be incommoded by standard formula across the board
  - Risk such as mortality is much the same everywhere!
- A more empirical approach is appropriate for relatively specialised undertakings operating in lines which may be heterogeneous across countries or types of exposures – standard formula SCR may well be too high or low for these.

The health insurance example

- EIOPA calibration report:
  - "Other examples are lines of business covering personal injury, health and lines covering pure financial loss as they are strongly influenced by legal and regulatory differences between member states, principally as a result of the following issues:
    - Strength of Public Health System
    - Access to health services
    - Funding of health costs
    - Strength of welfare systems
    - Access to courts
    - Basis of court awards"
- Calibration report showed great heterogeneity – some real, some arising from legacy data

Symmetry in application of USPs

- USPs are a useful tool both for undertakings and supervisors
- If supervisor reasonably believes that standard formula SCR understates true capital requirement, undertaking may be required to apply USP (e,g, specialised A380 insurer!)
- If undertaking reasonably believes that standard formula (materially) overstates true capital requirement, then it should in the interest of stakeholders apply for USP (for sake of helicopter insurance pricing!)
- If a specialised undertaking shows no interest in applying for USP, then supervisor may wish to understand why!

Data and methods

- Data should be appropriate and should be sufficiently complete and accurate to serve as the basis for calculation of a USP (may be a matter of professional actuarial judgment)
- Undertakings should be encouraged to test variety of methods – stability rather than accuracy may be most important criterion. Choice of method(s) should be able to be rationalised explicitly.
- Supervisors should find it advantageous to be able to rely on professional discipline of actuaries.
- Undertakings should be allowed / encouraged to collaborate on development of USPs where these are to reflect differences between countries.

Implications for ITS

- Ultimately likely that many hundreds of mainly specialist undertakings will either voluntarily or on supervisory initiative use USPs – limit burden for all parties involved (for sake of consumers).
- Include in ITS explicit requirement to root application in consideration of unique features of risk profile in an ORSA context.
- De-emphasise language which may constrain supervisors from an open-mindedly empirical consideration of data and methods for specialist firms particularly.
- Require actuarial function to endorse application

Discussion – Implementing Technical Standards for Approval of Ancillary Own Funds (AOFs)

- Yannick Bonnet

Comments

- Proportionality should be mentioned in the text. The ITS should be applied in a proportional way.
- Article 2 (definitions): The “material facts” definition seems to be too general; We suggest this paragraph to be reworded so that only facts which can significantly impact the supervisor´s decisions will be included under the scope of material facts.

Article 3 (General features)

- The requirement that the application letter should be signed by persons on behalf of the AMSB is not in line with neither the Level 1 nor the Level 2.
- The application should be forwarded by the undertaking's administrative, management or supervisory body. If required, the supervisor may check that the decision making process and documentation has been appropriate, and that the application has been appropriately signed.

Article 4 (Cover letter)

- EIOPA writes in paragraph 1 c) that the "*economic substance*" of a potential ancillary own-fund item, including how the item provides basic own funds once called, should be fully reflected in the application. In paragraph 1b) EIOPA states that the *assessment of the ancillary own fund* should be prudent and realistic. Further guidance is needed on how these two concepts should be combined; Should "economic substance " be understood as a "realistic consideration" or in line with the economic balance sheet approach ?

Article 5 (Supporting evidence)

- EIOPA is requiring firms to submit confirmation that *national law, in any relevant jurisdiction, does not prevent a call being made including in case of resolution, administration or insolvency proceedings have been initiated against the firm".*

  In our view this sentence should be deleted, because this should be the task of the supervisors.
- Ancillary own funds are often used during "deteriorating financial conditions" so point (e) seems to be in contradiction with those objectives and overly burdensome for firms.

Article 5 (contd)

- In paragraph 2(a) the term"affiliated arrangements" can be replaced by "commitments" as the translation seems to be a problem in several countries.
- The requirements in paragraph 3) (c) have been also included in article 4-1d) and article 5-2b). We suggest this paragraph to be deleted.

Article 7 (Assessment)

- The “stop-the clock” mechanism (the time required to submit further information) is not in line with the Level 1 text and it could delay enormously the whole process.
- Supervisory authorities should do everything in their power to reach a decision on the application as quickly as possible and within one month of receipt of the complete application.
- The time frames for each phase of the approval process should be reasonable and should not take longer than 3 months in exceptional circumstances (1 month to decide if the application is complete and 2 months to take a decision). In normal circumstances this period should be limited to 2 months (1+1).
- EIOPA should bear in mind that the timescales by which the ancillary own-fund items might be required can be very short. In that sense, those funds can be required when an undertaking breaches the SCR, during stress periods and as part of the recovery plan required by the supervisor authority which will be most of time on a 9 months time frame.

Discussion – Implementing Technical Standards for Approval of Special Purpose Vehicles (SPVs)

- Jari Eklund and Edgar Koning

General comments

- As Delegated Acts (DA) are still under drafting it is bit unclear whether or not there will become some issues to SPV (Level 2) articles that needs to be taken into account somehow. Also some of the issues that might be needed to clarify on the use of SPV' s are not covered in DA and therefore these can' t be brought up when commenting on this ITS
- As SPV' s can be of quite different volumes (balance sheet size) covering several or just one risk group and the investor groups behind SPV' s also varies (as some are more closed to all investors) it could be reviewed that this ITS takes into account the proportionality principle in a relevant manner.

General comments (contd)

- Grandfathering rules on SPV's? The draft DA text and this ITS proposal doesn't seem to mention anything about grandfathering rules on how these requirements have to be complied by a SPV that has got its approval before Solvency II comes into force. As this might be a critical issue for some of the SPV's it could be clarified in this ITS how this process works for them.

Article specific comments

- If the authorization of a SPV is withdrawn (as in art. 6 & 7 specified) it could be clarified what needs to be covered from SPV' s perspective towards the investors. The DA draft does cover the rights of the financing providers (in SPV5 article) that has to be covered in the contracts but leaves it bit open how the actual procedure works under winding-up process.
- Art 6 *'[…] the special purpose vehicle shall immediately inform its supervisory authority […] if there is a risk of non-compliance within the following three months'*: this specific wording may be interpreted such that there can be no non-compliance without the supervisory authority having received prior notice. There is, however, a not just theoretical possibility that a newly emerging risk leads to immediate non-compliance. Suggestion to add something along the lines of 'reasonable probability' .

Article specific comments (contd)

- It could be clarified in art. 7.1(c) that the not-fulfilling condition should be only on material errors. This could be done by clarifying this paragraph or writing a new one (as Art. 7.2 does for 7.1(d)) which clarifies in which conditions SPV is no longer fulfilling the conditions, is there some process with time constraints for SPV to fix the problem, etc.
- In art. 8, with multi-arrangement SPV's does it need to be covered somehow what are the risks if one of the insurers behind the SPV defaults or loses its business volume substantially? This results in lower premiums towards SPV without SPV probably not being able to adjust its year payments (interest) towards investors. Ultimately though, this ends up on investors risk (which probably is as it should) which might make this issue something not so much of EIOPA's concern.

Article specific comments (contd)

- Art 8 (1) *'[…] multi-arrangement SPV shall demonstrate to the satisfaction of its supervisory authority that its solvency cannot be adversely affected by the winding-up proceedings of any one of those insurance or reinsurance undertakings […]'*. It seems this demand can hardly be met in practice and, as such, it would become impossible to get approval for multi-arrangement SPV' s.
- Art 8 (2) suggests that SPVs cannot be used to achieve diversification benefits, while diversification is at the core of insurance and reinsurance. Is this really intended?

Article specific comments (contd)

- Annex I: We acknowledge that the treatment of solo vs. multi-arrangement SPVs evidences proportionality. However, the highly detailed description of required documentation in Annex 1 suggests quite the contrary.
- In Annex 1.12 it seems like SPV should always have a rating? As there seems not to be such requirements in the draft Delegated Acts and considering the fact that there might be (or become) quite different type of SPV' s it could be reviewed whether this requirement could be lowered under some situations.

SPV reporting (Pillar 3)

- No comments but recognized that these are articles that should be commented on but would require some good experience on working with SPV’ s.

IRSG input and next steps

- Today – do you agree with thrust for improvement and supporting arguments? Suggestions welcome.
- By 8 May we want to close the book on fresh suggestions so that we may draft formal opinion.
- In order to meet 30 June deadline, we will circulate draft opinion in advance of June meeting but would hope that final changes will be of generally minor character.

Relevant documents (re USPs)

- EIOPA QIS 5 final report (EIOPA-TFQIS5-11/001 14 March 2011)
- EIOPA/JWG Report on Calibration (EIOPA 11/163 12 December 2011)