

EIOPA-IRSG-17-14
31 August 2017

**Consultation Paper of EIOPA's first set of
advice to the European Commission on
the Solvency II review**

**Response by the EIOPA Insurance and
Reinsurance Stakeholder Group**

1. Executive Summary

The IRSG appreciates the opportunity to provide comments on EIOPA's draft advice to the European Commission.

The IRSG in particular welcomes that the draft advice reflects its previous proposals in the following areas:

- **Simplified calculations:** The IRSG welcomes that additional simplifications are being considered for various areas of the standard formula, in particular for lapse risk sub-module.
- **Reducing reliance on ECAIs:** the IRSG welcomes EIOPA's intended work on internal models and third-party providers, as well as the proposed simplifications for ratings of fixed-rate bond portfolios.
- **Guarantees and RGLA exposures:** the IRSG welcomes the expanded recognition of central government and RGLA guarantees and the proposed changes to Solvency II.
- **Risk mitigation techniques:** the IRSG welcomes the proposals to extend the recognition of short-term derivative contracts and to alter the provisions for partial recognition of risk mitigation provided by reinsurers which are temporarily in breach of their SCR.
- **Look-through for investment related undertakings:** the IRSG supports the proposed definition approach.
- **USPs:** The IRSG appreciates the introduction of a new USP method for non-proportional reinsurance and that consideration will be given at a later stage to USPs for nat cat, longevity and mortality once the recalibration works are completed.

However, the following areas do not reflect the previous input by the IRSG and therefore the IRSG encourages further consideration by EIOPA:

- **Simplified calculations:** The IRSG believes that non-prescribed simplifications should be permitted when they are immaterial to the calculated total SCR of the undertaking.
- **Reducing reliance on ECAIs:** EIOPA should be more ambitious in its efforts to encourage the industry to build internal credit assessment capabilities – these should ultimately be allowed for regulatory purposes and EIOPA should lead the way in developing such capabilities by developing a “best practice” model that, in addition to accounting measures, features probability of default and loss-given-default metrics.
- **Risk mitigation techniques:** The IRSG encourages further work is undertaken to ensure that the prudential framework does not restrict the development and use of legitimate risk mitigation techniques, such as Adverse Development Covers.
- **Look-through for investment related undertakings:** The IRSG believes the look-through should be optional, with appropriate prudential safeguards.
- **USPs:** the IRSG believes that EIOPA should be more ambitious regarding the relaxation of data requirements, the enlargement of areas of application, and the scope of standardised methods.

On the issue of **LAC DT**, the IRSG believes that further work is needed by EIOPA to provide a more accurate picture of the way it is dealt with across Europe. Once this analysis is finalised, the IRSG believes that EIOPA will have delivered on its mandate “*to report on the different methods currently applied and on their impact*”.

2. Simplified Calculations

The IRSG welcomes that EIOPA is considering the introduction of additional simplifications into various areas of the standard formula. The IRSG also welcomes EIOPA's clarification in relation to assessment of the error introduced by simplification.

As previously commented in its response to the DP, the IRSG considers that the ability to apply simplified calculations is beneficial in ensuring that a proportionate approach can be applied, thereby reducing the burden on small and medium sized undertakings.

The IRSG acknowledges the reference to specific sub-modules in articles 111(1) of the Solvency II directive but still believes that, in addition to the allowed simplifications, consideration should be given to facilitating the use of simplifications on a wider basis, and not solely following prescribed approaches. Non-prescribed simplifications permitted should be immaterial to the calculated total SCR of the undertaking and should be required to be fully, but not excessively, documented.

In the IRSG opinion, it is disproportionate to require all insurance and reinsurance undertakings to apply the standardised calculation when immaterial non-prescribed simplifications would in fact be justified and provide support in reducing the burden.

3. Reducing reliance on external credit ratings in the standard formula

The IRSG welcomes EIOPA's commitment to conduct an investigation into alternatives to nominated ECAs for regulatory supervision, such as the development of internal credit models and the use of third-party models. However, the IRSG notes that in addition to encouraging insurers to develop such models, EIOPA should be more ambitious and actually allow the use of such pre-approved credit models for regulatory purposes. The IRSG questions the implicit contradiction of the proposal to incentivise internal rating approaches but not to further extend these approaches. In fact EIOPA could attempt to develop and publish a "best-practice" model, similar to ones used for non-commercial third-party assessments (eg by central banks/authorities). The market could then use this as a foundation for developing tailored solutions, more suitable to each company's specific risks. Such a model should incorporate probability of default and loss-given-default parameters.

The IRSG also welcomes the proposed simplifications for plain vanilla corporate bond portfolios, but notes that applying excessively stringent conditions to qualify for using this simplification may restrict its practical application.

4. Treatment of guarantees, exposure guaranteed by a third-party and exposures to regional governments and local authorities (RGLA)

The IRSG welcomes the changes proposed by EIOPA, which are in line with previous IRSG suggested approaches. The IRSG appreciates in particular the changes around recognising central government and RGLA guarantees in the spread and concentration risk modules, extending the recognition of guarantees for Type 2 exposures (and specifically partially guaranteed residential mortgages) in the counterparty risk module, and recognising RLGA guarantees, not listed in ITS (EU) 2015/2011.

5. Risk-mitigation techniques

The IRSG appreciates EIOPA's analysis of risk mitigation techniques, specifically the areas it identified in its response to the discussion paper.

The IRSG welcomes the positive developments made in the proposals to extend recognition for short-term contracts. It further welcomes the proposals to remove the burdensome provisions for partial recognition of risk mitigation provided by a reinsurer temporarily in breach of its SCR.

The IRSG further recognises the complexity of adapting the prudential framework to facilitate the introduction and allowance of legitimate risk mitigation techniques. However, the IRSG believes that EIOPA should continue its work in this area to ensure that the prudential regime does not restrict the development, and use, of justifiable risk mitigation techniques, such as Adverse Development Covers and longevity swaps.

6. Look-through approach: investment related vehicles

The IRSG welcomes EIOPA's proposed definition approach of an investment related undertaking, which is in line with previous suggestions by the IRSG. It further welcomes that EIOPA proposes as a key criterion in the definition of an investment related undertaking that the sole purpose of the investment related undertaking is the holding of assets.

As previously indicated, the IRSG believes the look-through approach should be optional, as its application generates significantly high costs. Therefore the IRSG does not agree with EIOPA's suggestion to make look-through mandatory for all investment related undertakings. Specifically, IRSG proposes that the standard method should be allowed for insurers when they can prove that it leads to more conservative outcomes. Insurers could test conservativeness by, for example, basing their assessment on the target asset allocation or latest fund composition.

7. Undertaking specific parameters

The IRSG welcomes the proposed improvements by EIOPA with regards to the methods and areas of application:

- As regards methods, the IRSG appreciates the introduction of a new USP method for non-proportional reinsurance which deals with stop loss reinsurance contracts. This will supplement the current method which solely caters for excess of loss reinsurance programs. The IRSG equally appreciates EIOPA's call on the industry to provide more examples/solutions for USPs in the domain of lapse risk. The introduction of USPs for lapse risk should be considered, not least because of the substantial impact of lapse risk on the European life insurance market and the highly company specific characteristics in terms of lapse level and volatility. In doing so, due consideration should be given to the calibration of the mass lapse which is currently extremely conservative.
- In terms of areas of application, the IRSG appreciates that consideration will be given at a later stage to USPs for nat cat, longevity and mortality, once the recalibration and correlation works are completed.

However, the IRSG believes that EIOPA should be more ambitious regarding the data requirements, the areas of application, and the scope of the methods to be used.

- Data requirements should be adapted to ensure that although firms may not yet have enough historical data, the use of USPs is still possible, including for GSPs. The IRSG believes that the mandate given by the call for advice regarding assessing the data criteria to be met provides ample room for EIOPA to relax these.
- In addition, EIOPA should expand the USPs' application to all areas of life, non-life and health. As the Solvency II directive prohibits the use of USPs only in the market risk module and the

counterparty default risk modules, the limitation of their application to some specific areas of the underwriting risk modules is inappropriate.

- Finally, the USP framework should be more flexible and allow for simplifications. Given the importance of reinsurance as a risk mitigating tool, it is imperative to address the issues with recognition of all non-proportional reinsurance and other forms of reinsurance not well reflected in the standard formula. The IRSG considers the development of USP for Aggregate Excess of Loss Covers, which are similar to Stop Loss Reinsurance Covers, as a particular aspect of the framework which EIOPA could investigate further.

8. Loss-absorbing capacity of deferred taxes (LAC DT)

The IRSG has read with great interest the material provided for consultation by EIOPA on LAC DT, which is the result of the investigations carried out by EIOPA for understanding the various NSAs' practices to deal with LAC DT across Europe. As such, the IRSG considers that - once the analysis is complete - EIOPA will have delivered on its mandate from the EC which states: *"The calculation for reduction in capital requirements due to a deferred tax adjustment is complex, and requires a high level of supervisory judgement, resulting in possibly divergent practices in member states. EIOPA is asked to report on the different methods currently applied and on their impact."*

The IRSG notes however that EIOPA stresses on paragraph 455 that it is only the part of LAC DT that is demonstrated by future profits where NSAs have different approaches. EIOPA states subsequently that *"EIOPA will continue working on supervisory convergence and, if deemed necessary, may advise changes in the Delegated Regulation in its second response to the Call for Advice"*.

The IRSG understands therefore that, if further work on convergence is deemed necessary by EIOPA, it will be in the area of future profits. However, should EIOPA carry on with that work, the IRSG has the following comments it believes should be taken into account:

- LAC DT should be calculated in line with the principles of IAS 12 applying the relevant fiscal rules of the countries in which businesses operate.
- The Solvency II balance sheet is calculated on a notional market consistent basis. Over time, economic taxable profits will be realised, which can be used to recover notional deferred taxes. These future profits are expected from earning an investment margin on invested assets over and above the discount rate included in the Solvency II balance sheet and funding costs. The IRSG does not consider that it would be appropriate to limit the expected return to the shocked risk free rates.
- The loss absorbency of deferred taxes should be recognised not only when the undertaking can demonstrate credible future profits would be generated but also when the deferred tax assets will reverse in the future without negatively impacting future taxable income (e.g. due to credit spread risk shock).
- When taking account of new business in the calculation of the LAC DT, a fundamental consideration is the extent to which the relevant business would be able to recoup the shock loss and hence be able to write new business. This requires consideration of the basis on which the business in question can take management actions to improve its capital position (including whether it can be recapitalised). As part of the ongoing management of the capital position, businesses already assess the impact of stresses and the management actions that can be taken to restore the solvency position.
- The IRSG considers that the time horizons used in calculating the LAC DT should be based on the time horizon appropriate to the underlying business in question. The IRSG does not consider that it would be appropriate to impose an arbitrary limit on the time horizon used.

- Companies should also be allowed to use jurisdiction specific rules (for example tax credit in some jurisdictions can be used when two insurance companies go through a merger) in their calculations.
- Finally, the IRSG does not agree that the LAC DT should be limited to the net DTL, not least because this is inconsistent with the going concern basis of Solvency II. Setting the LAC DT to the amount of the net DTL effectively assumes that no future returns on assets and liabilities would be earned, and no future new business would be written by the business in question (and by extension the whole of the European/EU industry).