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

Response by the EIOPA Insurance and Reinsurance Stakeholder Group

0. General comment

The impact of all of the options proposed by EIOPA should be assessed jointly, and not just on a stand alone basis, before any move to implementation. It is important that the aggregate impact of proposed changes on the level of solvency cover of European insurance and reinsurance undertakings would be considered prior to implementation. Assessing the various proposals on an individual level does not represent a reliable basis for such an assessment.

Any modification of the Solvency II Delegated Regulation should support the balance between simplicity and risk-sensitivity.

1. Updated parameters for some standard parameters of premium and reserve risk

The IRSG welcomes the new calibrations for specific lines of business, based on more up to date data. However, we have the following comments on the draft advice

- Generally we question whether the data used by EIOPA is sufficient to justify the re-calibrations and note that the weighing by country leads to calibrations which are dominated by a few countries and so may not be representative
- We question whether it would be appropriate for the premium factors to take into account the levels of commission payable and whether it is appropriate to have the same factors for all countries concerned.
- We note that the mitigating impact of reinsurance and reserve risk covers such as Adverse Development Covers should be addressed. There are no new proposals included in this advice and we suggest that the advice should contain provisions to ensure that legitimate risk mitigation techniques can be properly reflected in the application of the standard formula.

2. Volume measure for premium risk

The IRSG welcomes that EIOPA seeks a more appropriate treatment of multi-year policies. However, Option 2 does not address multi-year contracts appropriately because it will overstate FPexisting and FPfuture. It is particularly wrong for portfolios where the start date of all contracts is the 1st January, which, for example is the case for health insurance in the Netherlands.

3. Recalibration of mortality and longevity risks

The IRSG does not agree that it would be appropriate to increase the mortality stress on the basis of the data used here which has a number of acknowledged shortcomings. One major shortcoming is that, because uncertainty increases over time, modelling expectation of life and translating the changes in expectation of life into instantaneous level shocks will overstate the level of shocks at shorter durations. This overstates the charge for contracts with significantly shorter terms than whole of life (such as term assurance). We suggest that further analysis should be undertaken, based on insured data, and addressing other shortcomings of the analysis, to support any proposed increase. The impact on undertakings which have tests associated with the application of Matching Adjustments should also be considered.

The IRSG agrees that more granular age-related stresses would provide for a more risk-sensitive SCR calculation but confirms its agreement that there would be little benefit from further granularity in mortality and longevity stresses.

4. Health Catastrophe Risk

The IRSG supports the proposals to introduce optional simplifications to the Health Catastrophe risk submodule.

5. Man Made Catastrophe Risk

The IRSG supports the proposals to introduce optional simplifications in this area and the extension of the definition for marine risk.

The IRSG also supports EIOPA proposals to change the identification of the maximum loss to be a net of reinsurance amount and the decisions taken by the EIOPA CAT work-stream on this.

6. Natural Catastrophe Risk

The IRSG supports the proposals to introduce optional simplifications to the NatCat risk submodules.

7. Interest rate risk

The IRSG re-iterates comments made in its response to EIOPA's discussion paper.

- The IRSG agrees that risk free downward shock scenario could at times be underestimated with the current methodology and therefore at some point changes to the methodology will be justified.
- However, the SII measurement approach is already conservative with respect to interest rate risk assessment and any potential changes should be considered together with an assessment of the overall conservative approach as part of the 2020 Review.
- We also note that there is next to no scientific body of work on how interest rates behave in negative territory and too little real-life experience to draw valid conclusions from. Consensus amongst economist seems to be that negative rates are "artificial" and "temporary".
- Given that, it seems at least unjustified to model the same downward shock as if we were in positive rates territory. In our view, there ought to be an upward bias in the distribution of probabilities when rates are below zero.
- The interest rate shock submodule should shock only the liquid part of the curve.

In assessing potential improvements to the methodology, the IRSG considers that the shifted approach may be the most appropriate. We acknowledge that a variation of Proposal A (200bp symmetric adjustment) or Proposal B (a combined approach) may be workable but consider that they are, as currently configured, excessively conservative. We consider that, if one of these approaches is to be used, the parameters should be reassessed, and that a floor based on the cost of holding cash should be included.

8. Market risk concentration

The IRSG supports EIOPA's providing clarification on single name exposures.

9. Currency risk at group level

The draft advice does not address the problems with the current currency translation risk methodology that the IRSG identified in its response to the discussion paper. Our response highlighted that:

- Currency risk at group level is currently not treated appropriately under the standard formula because it inappropriately penalizes groups for holding assets backing local solvency requirements in the local currency. The only way to avoid this would be for a company to back a local solvency requirement with the group head-office currency.
- The current method therefore incentivises a mismatch which creates rather than reduces group level currency risk. The standard formula should therefore be altered to recognize that good risk management (and possibly local regulatory requirement) requires the holding of local solvency capital requirements in local currencies. The definition of local solvency requirements should be based not on minimum requirements but, on those needed to avoid any regulatory intervention. A group could minimise FX translation risk either by allocating all excess capital (over that needed for local requirements) to the group currency or by distributing their excess pro-rata across the group. Exposure to FX translation risk would only be on those own funds which deviated from one of these two allocation approaches.

EIOPA's proposals would work only for very specific situations and not address the problems identified. General solutions that encourage appropriate currency risk management (as requested by the Commission) are possible and any increase in complexity would be limited and justified by the increased risk sensitivity.

10. Unrated debt

The IRSG recognises that investment in unrated debt, for instance through private placements, is an important element of the Commission's Capital Markets Union initiative. We are generally supportive of the proposals on unrated debt but some details require adjusting.

The IRSG considers that the requirement that the borrower be a company with limited liability should be removed. This limitation has the impact of excluding mutual undertakings which we consider not to be appropriate.

We are concerned that the "criterion yield" requirement will not work in practice and result in exclusion of a large amount of suitable lending. Although EIOPA has recognised that yields on unrated debt can be higher than rated debt for reasons other than higher riskiness, it still proposes to rely on rated debt yields as the basis for setting this criterion.

The IRSG does not support the suggestion that the total amount of unrated debt to be assigned a different risk factor should be limited to 5% of all investments. EIOPA argues (point 740) that:

"*such limit is in line with the freedom of investment as stated in Article 133 of the Solvency II Directive: the insurer is free to invest as much in unrated debt as it wants as long as all applicable legal requirements are met (e.g. the prudent person principle). It simply does not benefit from the more favourable treatment in terms of regulatory capital if the 5 % are exceeded. In this context it seems worth mentioning that Article 111(4) in the original text of the Solvency II Directive of 25 November 2009 contained an empowerment for the European Commission to adopt implementing measures to lay down quantitative limits. While the legal means would be different in this case the introduction of such a limit under certain conditions seems therefore to be reconcilable with the freedom of investment principle which was already included in the original text*". Such a limit can create problems, especially in markets where there is limited rated debt and there are sufficient safeguards and reporting requirements in Pillar 2 and Pillar 3 to ensure that companies manage, and supervisors can monitor, the risk appropriately. Referring to the original text is not appropriate as Member States and the European Parliament agreed not to have investment restrictions retained in

the Directive and the proposal by the EC to introduce restrictions by way of implementing measures was not retained.

11. Unlisted equity

The IRSG is supportive of the proposals.

12. Strategic equity investments

No comment.

13. Simplification of counterparty default risk

The IRSG is supportive of efforts to develop optional simplifications. The proposals, by increasing the options available, should help to provide for a more workable calculation. This optional simplification, while welcome, is overly prudent in assuming that 60% or more of the assets of the reinsurer are subject to collateral arrangements.

14. Treatment of exposures to CCPs and changes resulting from EMIR

The IRSG supports changes to reflect the reduction in risks achieved as a result of EMIR derivative regulation. The proposals recognise the very low risks involved for derivatives cleared through CCPs, but do not sufficiently recognise the reduction in risk also achieved through OTC derivatives. Under EMIR OTC derivatives will all be fully collateralised and therefore assuming only a 10% recovery rate is far too low and not a risk based calibration.

15. Simplification of look through approach

The IRSG is supportive of the proposed changes.

16. Look through approach at group level

No comment.

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

The IRSG is supportive of the establishment of principles and appropriate practices to apply to the projection of taxable profits after the application of stresses to insurance undertakings, taking into account the differences between the existing tax regimes at EU level and that the current framework already provides significant guidance on the issue of LAC DT.

It should be noted that there is no single right answer to potential prudential concerns on LAC DT. In fact, a number of considerations impact the decisions on LAC DT, including the nature of the business, the profile of undertakings, the tax regimes, etc.

The IRSG considers that any supervisory concerns should be addressed via appropriate supervisory dialogue, with appropriate knowledge of undertakings' specific business models.

The IRSG considers that the quest for convergence should not be taken to mean that the overriding goal is to have all supervisors applying identical restrictions, but rather that supervisors should apply similar process(es) for assessing LAC DT. Appropriate practices in the assessment of the likelihood of future profit and the identification of possible quantum of profit and timing of emergence post stress should be allowed. It is reasonable conceptually for insurers to project profits after a stress event, and the emergence of such profits across the industry is consistent with historic experience. Inevitably, there will be some subjectivity in an

insurer's assessment of its post stress prospects, and this may be justifiable with respect to the particular features of the business. For example, in the case of mandatory insurance a link to the real economy should be recognised. In the case of long-term products, components such as provision of pension services, fiscal consequences and substitutability need to be taken into account to assess likelihood of renewal or new business.

The establishment and oversight of principles and appropriate practices, with some consistency of regulatory application, is likely to lead relatively quickly to convergence in the approach to uncertainty and to dealing with complexity in such projections.

A key driver of the credibility of the projected emergence of any future profits post stress will be the depth of consideration of the impact of stresses and management actions to be taken to restore capital and market position which an undertaking can evidence. An established track record of capital strength, profitability and new business in stressful times will also be indicative of ability to generate profits post stress in the future.

We consider that, for an undertaking which can demonstrate a strong understanding of actions to be taken and positioning post stress, and which has an established track record in the areas mentioned above, it would not be unreasonable to project profits arising from new business over a medium to long term time horizon.

18. Risk Margin

The IRSG considers that the risk margin is excessive, particularly for long-term products and can lead to unnecessary impact on the price and/or availability of certain (long-term) products. We consider that the CoC at 6% is at an inappropriately high level in light of the level of risk free interest rates and lowering it would be the most straightforward way of achieving more appropriate risk margin outcomes.

EIOPA has provided figures which shows the aggregate risk margin for Europe was in excess of euros 200bn. Other analysis has shown that, for long-term products such as funeral insurance, the risk margin can easily exceed 100% of the SCR. We are not aware of any evidence that it is realistic to argue that the cost of transferring a portfolio of funeral insurance contracts requires a risk margin greater than the capital needed to protect that portfolio to a 1 in 200 confidence level despite the long-term nature of such contracts. EIOPA does not seem to have made any attempt to explain and justify either with theory or empirical evidence such high levels of risk margin.

The IRSG considers that EIOPA’s conclusions on the Cost of Capital do not give prominence to the range of outcomes in the analysis they discuss and refer to, and this could be leading to a bias in how the results of that analysis are presented. This is particularly the case with respect to the assumptions on equity risk premium (where EIOPA place too much weight on the backward looking approach to derivation), financing structure (where there are internal inconsistencies in EIOPA’s approach) and the final adjustment applied (which does not reflect the specificity of the risk margin pure insurance risks framework).

The IRSG also requests consideration of how to project the SCR over the lifetime of a portfolio in order to ensure that the risk margin is not artificially increased by treating the point in time SCRs as purely independent in the calculation. This requirement, combined with the level of the CoC, can be particularly onerous for long term life assurance contracts, e.g. annuities or funeral expenses plans.

We consider that the risk margin at current levels is excessive and harms consumers by inappropriately increasing premiums and reducing access to insurance products.

19. Comparison of own funds in insurance and banking sectors

The IRSG is supportive of the proposals.

We suggest that there are some areas where differences between the banking and insurance regimes are not justified and which lead to an onerous treatment for insurance undertakings and that these should be addressed. We refer for instance to the first call, early redemption and maturity dates for tier 1 and tier 2, and the treatment of PLAMs.

20. Capital instruments only eligible as Tier 1 up to 20% of total tier 1

The limit introduced by Article 82(3) should be deleted, as it is contrary to the political agreement in the Solvency II Framework Directive and introduces unnecessary complexity in dealing with own fund items. The IRSG regrets that EIOPA did not take account of its already stated opinion on the earlier discussion paper and did not indicate in its consultation paper why it departed from the IRSG advice.

Article 82(3) of the Delegated Regulation introduces the 20% limit which is in fact introducing the idea of sub-tiers which was specifically and intentionally deleted by the Council and the EP during the negotiations of the Solvency II Framework Directive. The EC had accepted this deletion. Article 82(3) is therefore not in line with the delegated power on which it is based (Article 99 of the Solvency II Framework Directive). This matter was picked up by the EP when it was scrutinizing the Delegated Regulation. The EC refused to follow the suggestion of the EP to delete Article 82(3).

f the 20% limit for restricted Tier 1 instruments were removed, the restriction should not be retained on the ıse of lower quality transitional own funds.