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EIOPA's Supervisory Statement

Solvency II: Application of the proportionality principle in the supervision of the Solvency Capital Requirement

Executive summary

This statement outlines the outcome of the discussion and analysis of the proportionality principle in the supervisory review process, in particular in the supervision of the Solvency Capital Requirement (SCR) calculated in accordance with the standard formula. This statement is without prejudice to the application of the relevant provisions of Directive 2009/138/EC (Solvency II Directive) and Commission Delegated Regulation (EU) 2015/35 (Delegated Regulation), in particular on the simplifications in the standard formula.

EIOPA identified potential divergences in the supervisory practices concerning the supervision of the SCR calculation of immaterial sub-modules.

EIOPA agrees that in case of immaterial SCR sub-modules the principle of proportionality applies regarding the supervisory review process, but considers it is important to guarantee supervisory convergence as divergent approaches could lead to supervisory arbitrage.

EIOPA is of the view that the consistent implementation of the proportionality principle is a key element to ensure supervisory convergence for the supervision of the SCR. For this purpose the following key areas should be considered:

Proportionate approach

Supervisory authorities may allow undertakings, when calculating the SCR at the individual undertaking level, to adopt a proportionate approach towards immaterial SCR sub-modules, provided that the undertaking concerned is able to demonstrate to the satisfaction of the supervisory authorities that:

a) the amount of the SCR sub-module is immaterial when compared with the total basic SCR (BSCR);
b) applying a proportionate approach is justifiable taking into account the nature and complexity of the risk;
c) the pattern of the SCR sub-module is stable over the last three years;
d) such amount/pattern is consistent with the business model and the business strategy for the following years; and
e) undertakings have in place a risk management system and processes to monitor any evolution of the risk, either triggered by internal sources or by an external source that could affect the materiality of a certain sub-module.

This approach should not be used when calculating SCR at group level.

An SCR sub-module should be considered immaterial for the purposes of the SCR calculation when its amount is not relevant for the decision-making process or the judgement of the undertaking itself or the supervisory authorities. Following this principle, even if materiality needs to be assessed on a case-by-case basis, EIOPA recommends that materiality is assessed considering the weight of the sub-modules in the total BSCR and that each sub-module subject to this approach should not represent more than 5% of the BSCR or all sub-modules should not represent more than 10% of the BSCR.

For immaterial SCR sub-modules supervisory authorities may allow undertakings not to perform a full recalculation of such a sub-module on a yearly basis taking into consideration the complexity and burden that such a calculation would represent when compared to the result of the calculation.

Prudent calculation

For the sub-modules identified as immaterial, a calculation of the SCR sub-module using inputs prudently estimated and leading to prudent outcomes should be performed at the time of the decision to adopt a proportionate approach. Such calculation should be subject to the consent of the supervisory authority.

The result of such a calculation may then be used in principle for the next three years, after which a full calculation using inputs prudently estimated is required so that the immateriality of the sub-module and the risk-based and proportionate approach is re-assessed.

During the three-year period the key function holder of the actuarial function should express an opinion to the administrative, management or supervisory body of the undertaking on the outcome of immaterial sub-module used for calculating SCR.

Risk management system and ORSA

Such a system should be proportionate to the risks at stake while ensuring a proper monitoring of any evolution of the risk, either triggered by internal sources such as a change in the business model or business strategy or by an external source such as an exceptional event that could affect the materiality of a certain sub-module.

Such a monitoring should include the setting of qualitative and quantitative early warning indicators, to be defined by the undertaking and embedded in the ORSA processes.

Supervisory reporting and public disclosure

Undertakings should include information on the risk management system in the ORSA Report.

Undertakings should include structured information on the sub-modules for which a proportionate approach is applied in the Regular Supervisory Reporting and in the Solvency and Financial Condition Report, under the section "E.2 Capital Management - Solvency Capital Requirement and Minimum Capital Requirement".

Supervisory review process

The approach should be implemented in the context of on-going supervisory dialogue, meaning that the supervisory authority should be satisfied and agree with the approach taken and be kept informed in case of any material change.

Supervisory authorities should inform the undertakings in case there is any concern with the approach. In case the supervisory authority has any concern the approach should not be implemented or might be implemented with additional safeguards as agreed between the supervisory authority and the undertaking.

In some situations supervisory authorities may require a full calculation following the requirements of the Delegated Regulation and using inputs prudently estimated.

1. Introduction

1.1. Proportionality is a fundamental principle of Union law as provided for in Article 5(4) TEU and also a key element of the Solvency II regulation. In this regime the principle of proportionality appears on two levels: on the level of regulation and on the level of supervision.

1.2. As stated in Recital (19) of the Solvency II Directive, it should not be too burdensome for small and medium-sized insurance undertakings. One of the tools to achieve this objective is the proper application of the proportionality principle. That principle should apply both to the requirements imposed on the insurance and reinsurance undertakings and to the exercise of supervisory powers.

1.3. Article 29(3) of the Solvency II Directive states that its requirements need to be applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking.

1.4. With regards to proportionality and simplifications in the calculation of the SCR according to the standard formula, specific principles and simplified methods have been identified and introduced by the Delegated Regulation in Title I, Chapter V (Solvency capital requirement standard formula), Section 1, Subsection 6 (Proportionality and simplifications).

1.5. On the other hand, proportionality goes beyond the rules of the Solvency II Directive. As stated in Article 29(3), the requirements need to be applied in a manner, which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking. Consequently, supervisory authorities are required to follow a proportionate approach in the supervision of insurance and reinsurance undertakings.

1.6. EIOPA supports the application of the proportionality principle in the supervisory review process as clearly stated in the EIOPA Common Supervisory Culture. Moreover, EIOPA is attentive to the convergence of supervisory practices and to build a level-playing field across Europe also in the application of the proportionality principle.

1.7. One form of proportionality is to consider the materiality of the issue at stake. Materiality is assessed by the possible influence in the decision-making process or the judgement of the users of the item subject to materiality, including the undertaking itself and supervisory authorities.

1.8. Against this background, EIOPA has identified potential divergences in the supervisory practices concerning the supervision of the SCR calculation of immaterial sub-modules.

1.9. The SCR standard formula is intended to reflect the risk profile for most insurance and reinsurance undertakings.

1.10. However, the practice shows that the calculation of some of the sub-modules of the SCR standard formula may be considered complex by some insurance and reinsurance undertakings, taking into account the nature, scale and complexity of their risks. This applyes mainly to small and medium sizes undertakings but is not limited to them.

1.11. EIOPA agrees that in case of immaterial SCR sub-modules the principle of proportionality applies regarding the supervisory review process, but considers it is important to guarantee supervisory convergence as divergent approaches could lead to supervisory arbitrage.

1.12. The aim of this Supervisory Statement is to promote convergence in the adoption of proportionate supervisory practices while ensuring a prudent approach in the calculation of immaterial SCR sub-modules, by:

a) prudent calculation of the sub-modules;
b) proper management and adequate monitoring of the risks by the undertakings;
c) an adequate early warning system established by the undertakings; and
d) timely and effective supervisory dialogue.

2. Elements of a proportionate approach

Identification and decision

2.1. Supervisory authorities may allow undertakings, when calculating the SCR at individual undertaking level, to adopt a proportionate approach towards immaterial SCR sub-modules, provided that the undertaking concerned is able to demonstrate to the satisfaction of the supervisory authorities that:

a) the amount of the SCR sub-module is immaterial when compared with the total basic SCR (BSCR);
b) applying a proportionate approach is justifiable taking into account the nature and complexity of the risk;
c) the pattern of the SCR sub-module is stable over the last three years;
d) such amount/pattern is consistent with the business model and the business strategy for the following years; and
e) undertakings have in place a risk management system and processes to monitor any evolution of the risk, either triggered by internal sources or by an external source that could affect the materiality of a certain sub-module.

2.2. This approach should not be used when calculating SCR at group level.

2.3. An SCR sub-module should be considered immaterial for the purposes of the SCR calculation when its amount is not relevant for the decision-making process or the judgement of the undertaking itself or the supervisory authorities. Following this principle, even if materiality needs to be assessed on a case-by-case basis, EIOPA recommends that materiality is assessed considering the weight of the sub-modules in the BSCR and that each sub-module subject to this approach should not represent more than 5% of the BSCR or all sub-modules should not represent more than 10% of the BSCR.

2.4. For immaterial SCR sub-modules supervisory authorities may allow undertakings not to perform a full recalculation of such a sub-module on a yearly basis taking into consideration the complexity and burden that such a calculation would represent when compared to the result of the calculation.

2.5. The approach identified in the previous paragraph may only be adopted to a number of sub-modules for which the sum of the amount of the SCR calculated using prudent inputs is also immaterial.

2.6. The decision for which sub-modules a proportionate approach should be applied to immaterial sub-modules should consider the burden and complexity of the calculation[1] and any other entity specific circumstances.

Calculation of the SCR for immaterial sub-modules

2.7. For the sub-modules identified as immaterial, a calculation of the SCR sub-module using inputs prudently estimated and leading to prudent outcomes should be performed at the time of the decision to adopt a proportionate approach. Such calculation should be subject to the consent of the supervisory authority and will be applied starting from the following financial year end (i.e. no re-statement of the previously submitted SCR).

2.8. Applying a less frequent calculation of the immaterial SCR submodule cannot lead to an underestimation of the risk according to the 99.5% 1-year Value-at-Risk measure. The error introduced by a less frequent calculation of the immaterial SCR submodule should be compensated by applying sufficient prudence.

2.9. The result of such a calculation may then be used in principle for the next three years, after which a full calculation using inputs prudently estimated is required so that the immateriality of the sub-module and the risk-based and proportionate approach is re-assessed. Undertakings should stop the proportionate calculation in case of material change of the risk profile which may impact the sub-module(s) considered in the proportionate calculation.

2.10. During the three-year period the key function holder of the actuarial function should express an opinion to the administrative, management or supervisory body of the undertaking on the outcome of immaterial sub-module used for calculating SCR.

Risk management system and ORSA

2.11. The adoption of a proportionate approach for certain sub-modules should not affect the compliance with any requirement on adequate and effective risk-management systems comprising strategies, processes and reporting procedures. These are necessary to identify, measure, monitor, manage and report the risks, on a continuous basis, at both individual and aggregated level, to which they are or could be exposed, and their interdependencies.

[1] Calculations on the basis of scenario (e.g. interest rates) are expected to be more complex than the ones calculated on factor-based approach (e.g. spread).

2.12. Such a system should be proportionate to the risks at stake while ensuring a proper monitoring of any evolution of the risk, either triggered by internal sources such as a change in the business model or business strategy or by an external source such as an exceptional event that could affect the materiality of a certain sub-module.

2.13. Such a monitoring should include the setting of qualitative and quantitative early warning indicators, to be defined by the undertaking and to be embedded in the ORSA processes. Early warning indicators should be entity specific and take into consideration at least the following characteristics:

a) the number of sub-modules under the proportionate approach;
b) the nature of risks under the proportionate approach;
c) the interconnectedness between the risks;
d) the inputs to be monitored; and
e) the risk drivers/sources of volatility of the risks.

2.14. Undertakings should define thresholds for the early warning indicators which would trigger the full calculation of the specific sub-module using inputs prudently estimated as well as a monitoring process to assess if the early warning indicators are trigerred.

2.15. In case any early warning indicator is trigerred, undertakings should communicate the situation to the supervisory authority immediately.

Supervisory reporting and public disclosure

2.16. Undertakings should include information on the risk management system referred to in the previous paragraphs in the ORSA Report.

2.17. Undertakings should include structured information on the sub-modules for which a proportionate approach is applied in the Regular Supervisory Reporting, under the section "E.2 Capital Management - Solvency Capital Requirement and Minimum Capital Requirement", including at least the following information:

a) identification of the sub-module(s) for which a proportionate approach was applied;
b) amount of the SCR for such a sub-module in the last three years before the application of proportionate approach, including the current year;
c) the date of the last calculation performed following the requirements of the Delegated Regulation using inputs prudently estimated; and
d) early warning indicators identified and triggers for a calculation following the requirements of the Delegated Regulation and using inputs prudently estimated.

2.18. Undertakings should also include structured information on the sub-modules for which a proportionate approach is applied in the Solvency and Financial Condition Report, under the section "E.2 Capital Management - Solvency Capital Requirement and Minimum Capital Requirement", including at least the identification of the sub-module(s) for which a proportionate calculation was applied.

2.19. An example of structured information to be included in the regular supervisory report in line with Article 311(6) of the Delegated Regulation is as follows:

Example: Sub-modules for which a full calculation was not applied

Sub-modules	SCR Y-3	SCR Y-2	SCR Y-1	SCR Y*[1]	Date of last calculation (Y-1)	EWI1*[2]	EWI2	EWI3 …

*[1] If proportionate approach is applied in SCR end 2019 calculation, Y-3 will be 2016, Y-2 2017, Y-1 2018. These are the three years used to assess volatility and amount. In 2019 a calculation following the requirements of the Delegated Regulation and using inputs prudently estimated is required and the amount may be used moving forward. In 2019, Y is 2019 and the date of full calculation should be 31/12/2019.

When reporting 2020, assuming that no early warning was triggered, Y-3 is still 2016, Y-2 2017 and Y-1 2018, Y is 2020 but it is assumed that the amount is the same as in 2019 and the date of full calculation is 31/12/2019.

*[2] Divided in 3 sub-columns with description of the Early Warning Indicators, threshold defined and end of the year amount

2.20. This proportionate approach should also be reflected in the quantitative reporting templates to be submitted. In this case the templates would reflect the amounts used for the last full calculation performed.

Supervisory review process

2.21. The approach described above should be implemented in the context of on-going supervisory dialogue, meaning that supervisory authority should be satisfied and agree on the approach taken and be kept informed in case of any material change.

2.22. Supervisory authorities should inform the undertakings in case there is any concern with the approach. In case the supervisory authority has any concern the approach should not be implemented or might be implemented with additional safeguards as agreed between the supervisory authority and the undertaking. The concern might be related to:

a) the materiality of the sub-module(s);
b) impact of the sub-module in the overall risk-profile of the undertaking,
c) impact of the sub-module in the context of the national market for the affected line of business;
d) the functioning of the risk management system in general; and
e) the undertaking classification in the Risk Assessment Framework (e.g. in risk/impact class 4).

2.23. In some situations supervisory authorities may require a full calculation following the requirements of the Delegated Regulation and using inputs prudently estimated. Examples of such situations may be:

a) material changes in the risk classification of the undertaking under the supervisory authority's Risk Assessment Framework; and
b) any concerns regarding the adequacy of the system of governance.