BRIEFING

Scrutiny papers

European Parliament

Review of the Solvency II implementing measures

Committee on Economic and Monetary Affairs

Scrutiny Session of 2 April 2019

This briefing has been drawn up to support ECON's work on the scrutiny of delegated acts, in particular as regards the discussion on the review of the implementing measures under **Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance** (Solvency II[1]) .

In brief

Solvency II became fully applicable on 1 January 2016, aiming to introduce a modernised risk-based prudential and supervisory regime for insurance and reinsurance undertakings in the European Union. Two years after the entry into application, the Commission has conducted a review of the implementing measures contained in **Delegated Regulation (EU) 2015/35** ("Solvency II DA"), adopted on 10 October 2014. The Solvency II DA was first updated in the context of the Capital Markets Union (CMU), reviewing risk calibrations for **infrastructure investments**. Before the overall **review of Solvency II** by 2021, the Commission adopted further amending delegated acts, relating to the treatment of **simple, transparent, and standardised (STS) Securitisation investments by insurers** and the review of specific items of the Solvency II Capital Requirement Standard formula ("**SCR review**"). This briefing focuses primarily on this SCR review of the Solvency II DA, for which the Commission in particular identified three themes: proportionality, the removal of unintended technical inconsistencies, and the removal of unjustified constraints for financing.

CAPITAL MARKETS UNION: INFRASTRUCTURE AND STS SECURITISATION INVESTMENTS

As part of its Capital Markets Union (CMU) initiative, the Commission amended the Solvency II DA on 8 June 2017 with more risk sensitive calibrations for infrastructure and European long-term investment funds. Capital charges for debt investments in qualifying infrastructure corporates were on average reduced by 25%. CMU furthermore included the intention to amend the Solvency II DA by including new prudential calibrations for simple, transparent and standardised (STS) securitisation products. The Solvency II DA was also updated to ensure consistency with this framework the STS

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[1] 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 (Solvency II), OJ L 335, 17.12.2009, p. 1–155.

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Regulation[2], which applies as of 1 January 2019. On 1 June 2018, the Commission adopted the amending Solvency II DA with the STS amendments, including changes concerning:

- **New risk calibrations** for non-senior tranches of STS securitisations, with technical improvements also to be made for calculations of the calibrations for senior tranches.
- **An alignment of the definitions** concerning securitisation of the Solvency II DA with the STS Regulation.
- **A repeal of certain articles of the Solvency II DA** related to risk retention and due diligence, to avoid that insurers are subject to different requirements in their capacity of institutional investors under the STS Regulation.

THE SCR STANDARD FORMULA REVIEW IN THE SOLVENCY II DA

Recital 150 of the Solvency II DA foresees a review of the methods, assumptions, and standard parameters used for the calculation of the Solvency Capital Requirements (SCR) with the standard formula. Following a consultation phase that closed early 2018, EIOPA published two sets of technical advice on specific items in the Solvency II DA. The Commission was to perform its review of specific items of the SCR standard formula before December 2018 and published a draft of the amending Solvency II DA on 9 November 2018. It adopted the amended Solvency II DA on 8 March 2019, with a scrutiny period for Parliament and Council of three months, extendable once. The amending DA is based on the technical advice by EIOPA and contains three main themes: proportionate and simplified application of the requirements, removal of unintended technical inconsistencies and removal of unjustified constraints for financing.

Proportionate and simplified application of the SCR standard formula requirements

Following Article 29(4) of Solvency II, all implementing measures adopted shall take into account the principle of proportionality, in particular in relation to smaller insurers. Aiming for a proportionate and simplified application of the SCR standard formula requirements, the Commission proposes to cover existing simplifications, the non-life catastrophe risk sub-module, and the counterparty default module:

- In general, as recommended by EIOPA, the adopted amending DA allows for more flexibility in the calculations, by means of optional **simplified formulas** for the calculation of risks such as lapse and life and health mortality and a reduced data-collection burden.
- The Commission furthermore followed EIOPA's advice on the simplification of the **look-through approach**, e.g. through a "carve out" from the 20% limit for unit linked and index linked products under certain conditions, and the possibility to use the latest reported fund composition where the look-through approach cannot be applied. The amending DA includes an alignment of the scope of the look-through approach with respect to investments in non-consolidated related undertakings between the solo and group level.

Removal of unintended technical inconsistencies

Recital 150 of the Solvency II DA foresees that the Commission uses experience gained by (re)insurance undertakings in its SCR Review. Further to EIOPA's consultation process and technical advice, the Commission e.g. included the following:

- As regards the **risk mitigation techniques** (RMT), for which EIOPA for example recommended better recognising rolling hedging strategies where the RMT is regularly replaced with similar

[2] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, OJ L 347, 28.12.2017, p. 35–80.

instruments, the amending DA introduces an amended treatment to reflect these developments in risk management practices.

- The amending DA includes revised **recalibrations** for the non-life premium and reserve risk standard deviations in medical expense, credit and suretyship, assistance, legal expenses, worker's compensation and non-proportional health reinsurance.
- As for the assessment of credit risk and the reduction of the reliance on "**External Credit Assessment Institutions"** ("ECAIs") ratings in the SCR, the amending DA includes simplified calculations for the credit risk module by nominating only one if the ECAI covers 80% of the debt portfolio. In this case, the insurer may assume that the assets not covered by the ECAI are of Credit Quality Step 3 unless there is evidence that a significant part is of lower credit quality.
- The amending DA also intends to create **consistency across financial sectors** by extending the scope for the recognition of guarantees issued by regional governments and local authorities (RGLA) to align insurance with the banking framework (Directive 2013/36/EU (CRD) and Regulation (EU) No 575/2013 (CRR)). A second alignment concerns adjustments in the treatment of derivatives, following the adoption of the European Market Infrastructure Regulation (Regulation (EU) No 648/2012 (EMIR)).
- Following its analysis, in its first advice, of practices to calculate **the loss-absorbing capacity of deferred taxes** (LAC DT), EIOPA had proposed to address divergences herein through a set of nine key principles. In the amending DA, the Commission introduces new requirements on the calculation of the LAC DT. The application date of these provisions would be set to 1 January 2020.

On 18 September 2018, the Chair of the ECON Committee wrote a letter to the Commission Vice President in follow up of the earlier scrutiny slot on Solvency II, which took place on 16 May 2018. Whilst welcoming that the Commission, at this stage, did not intend to follow EIOPA's suggestion on the **strengthened capital requirement for interest rate risk to reflect the potential of negative interest rates**, this first letter in particular draws attention to the risk margin.

In this regard, Parliament had suggested, also in a second letter of 6 December 2018, to investigate the possibility of reducing the current risk margin. In its technical advice, EIOPA had recommended that the **cost of capital** rate of 6% remains unchanged and that other aspects of the risk margin should be addressed in the upcoming 2020 Solvency II overall review (*see below*). In the Vice President's replies to the letters by the Chair of the ECON Committee, dated 27 November 2018 and 12 March 2019, the Commission supported this view taken in the technical advice of EIOPA and underlines that EIOPA's assessment provided evidence that the cost of capital rate should rather be lowered.

A third item from the letter exchange that the Commission is likely to investigate in detail throughout the 2020 Solvency II overall review, was the **volatility adjustment**, including the activation of the national component. Parliament's letters had suggested to calculate the country component be calculated at the end of the period if the condition are met at any time during the reporting period itself, based on a daily calculation.

Removal of unjustified constraints for financing

In the context of the CMU, EIOPA was also asked to consider changes to remove unjustified constraints to financing, mostly related to long-term investment. In particular, this concerns EIOPA's proposal regarding the treatment of **unrated debt and unlisted equity**. Suggestions aimed to provide these asset classes with the same credit ratings and capital charges as rated debt and listed equity, enhancing insurers' capacity to invest in private placement offerings and in private equity. For unrated debt, this included criteria put forward by EIOPA to assess in which cases the same treatment can be provided, related to financial ratios and yield. For unlisted equity, conditions relate to criteria on underlying equity investments, on vehicle, on own risk management and on similarity. EIOPA also provided information on the application of the Solvency II DA criteria for the identification of **strategic equity investments** by insurance and reinsurance undertakings as well as by National Supervisory Authorities ("NSAs").

After the suggestion by stakeholders and Member States, including the ECON Committee (*see below)* to put forward more ambitious actions to stimulate long-term investments in equity, the Commission adjusted some criteria that were proposed by EIOPA and introduced a **new asset class for long-term holdings in equity investments**. The Commission accompanied its amending DA by a Staff Working Document (SWD) on supporting insurers' investment in equity and unrated debt. The SWD underlines the importance of attenuating any excessive focus on short-term investment in capital markets. It takes stock of investment strategies in the insurance sector and assesses different initiatives supporting both long-term investment in equity as well as investment in unrated debt.

> One of the matters contained in the letter exchange between the Chair of the ECON Committee and the Commission Vice President, was the treatment of equities - including the need to revise measures on **equity shock for long-term equity investments.** The amending DA accordingly extends the reduced capital charges (22%) applicable to the duration-based equity sub-module, to long-term investments in equity of EEA companies meeting certain criteria. In his letter of 12 March 2019, the Commission Vice President furthermore notes that Parliament's concerns on the design of the criteria for this new asset class, were addressed by reducing the minimum holding period requirement and by removing any reference to ring-fencing.

THE REVIEW OF THE SOLVENCY II DIRECTIVE

The Solvency II DA also foresees an overall **review of the Solvency II framework**, including the treatment of long-term guarantees (LTG) and measures on equity risk, to be completed by 1 January 2021. For this, EIOPA annually reports on the impact of the application of the LTG measures and the measures on equity risk, and will issue an opinion to the Commission on the basis of which the Commission will submit a report and, if deemed necessary, legislative proposals. The Commission sent a formal request to EIOPA on 11 February 2019 for technical advice on the review of the 2020 Solvency II Directive. Criticising the staged approach of the Solvency II review, stakeholders had suggested postponing in particular changes to the interest rate risk module until the review of the LTG package.

> In his second letter to the Commission Vice President, the Chair of the ECON Committee regrets that most of Parliament's priorities were only to be taken up at a later stage - as stated in the Commission's draft DA when it was published at its Better Regulation portal for a four-week consultation -, "*in particular in its preparation for the review of the Solvency II Directive in 2020*".

OVERVIEW OF EIOPA's PREPARATORY WORK FOR THE SCR REVIEW

	EIOPA's first set of advice	EIOPA's second set of advice
Mandate	18 July 2016	21 February 2017
Discussion Paper	5 December 2016	(idem)
Consultation Paper	4 July 2017	6 November 2017
Final Report	30 October 2017	28 February 2018