

EIOPA Reveals Proposed Solvency II Reforms

21 October 2019

On 15 October 2019, the European Insurance and Occupational Pensions Authority (“EIOPA”) published its proposed [reforms](#) to Solvency II. This forms part of the formal review mechanism within Solvency II, which requires the European Commission (the “Commission”) to review certain areas before the end of 2020.

As part of the interim review of Solvency II’s delegated regulation in 2018, the Commission carried out a review of methods, assumptions and standard parameters used when calculating solvency capital requirements (“SCR”). However, certain issues, including interest rate risk, were specifically deferred to the 2020 review.

It is of note that in the call for advice issued by the Commission to EIOPA in February 2019 (the “Call for Advice”), the Commission stressed that “the fundamental principles of [Solvency II] should not be questioned in the review”¹ and EIOPA itself has made clear in its press release that it believes that “the Solvency II framework is overall working well”.²

EIOPA raised a number of proposals in the 878-page document, covering a range of topics, including the 19 areas of focus highlighted in the Call for Advice. Separate consultations on Solvency II [reporting and disclosure](#) and [insurance guarantee schemes](#) were both published in July 2019. Comments on these were due by 18 October 2019.

The key EIOPA proposals are broadly divided into three parts:

- the review of the long-term guarantee measures;
- the potential introduction of new regulatory tools; and
- revisions to the existing Solvency II framework.

¹ <https://eiopa.europa.eu/Publications/Requests%20for%20advice/signed%20note.pdf>.

² <https://eiopa.europa.eu/Pages/News/EIOPA-consults-on-technical-advice-for-the-2020-review-of-Solvency-II.aspx>.

The Review of the Long-Term Guarantee Measures

- **Risk margin:** EIOPA proposed making no change to the risk margin calculation or to the cost of capital rate—both of which have long been a point of contention for many in the industry, particularly in the United Kingdom.
- **Volatility adjustment design:** This was the largest section of the report. EIOPA proposed two technical changes with respect to the representative portfolios against which the volatility adjustment is calculated. However, EIOPA also identified seven deficiencies in the calculation of the volatility adjustment and eight options as to how the design of the volatility adjustment could be reformed. EIOPA failed to make a recommendation on these options and indicated that this will be a contentious reform in the 2020 review. EIOPA plans to decide on whether the volatility adjustment should be subject to supervisory approval following the selection of a design.
- **Matching adjustment:** EIOPA has made two proposals in relation to the matching adjustment:
 - removal of the limitation to claiming diversification benefits in the SCR when first using matching adjustment portfolios and the standard formula, and
 - allowing restructured assets into the matching adjustment portfolio, provided that such assets, in addition to meeting the other eligibility criteria:
 - provide a “sufficiently fixed level of income”;
 - the reconstructed cash flows are supported by loss absorbency features;
 - do not result in additional matching adjustments where they include financial guarantees; and
 - enable underlying risks to be properly identified, measured and reported.

This clarification should enable a wider range of assets to be included in matching adjustment portfolios.

The Potential Introduction of New Regulatory Tools

- **Macro-prudential tools:** EIOPA has planned to introduce tools to address systemic risk in the sector for a long time. The measures proposed by EIOPA are wide-ranging and based on extensive consultations. Generally speaking, the measures are designed to incorporate the macro-prudential perspective into the prudential framework. For example, EIOPA proposed that:
 - the supervisory authorities should be granted the temporary power to freeze the redemption rights of policyholders, in exceptional circumstances;
 - the supervisory authorities should have the power to require systemically important (re)insurers to produce systemic risk management plans;
 - the supervisory authorities should have the power to set a capital surcharge to address certain sources of systemic risk and soft thresholds for action at the market level if certain exposures increase dramatically or reach a significant level;
 - Own Risk and Solvency Assessments (the “ORSA”) should take account of the macro-prudential perspective; and
 - the prudent person principle should take account of macroeconomic concerns.
- **Recovery and resolution:** As part of the drive for further harmonisation, EIOPA suggested that minimum standards for a recovery and resolution framework should be established to protect policyholders and maintain the financial stability of the European Union. Generally speaking these involve: more interaction with supervisory authorities in a pre-emptive manner; granting greater powers to supervisory authorities to intervene; each Member State having an official administrative resolution authority with significantly expanded powers; and requirements for most (re)insurers to maintain recovery plans. In addition, EIOPA suggested that non-compliance with the SCR should be a trigger for entry into recovery.

Revisions to the Existing Solvency II Framework

- **Proportionality:** As one of the overarching principles of Solvency II, EIOPA proposed to reinforce proportionality. EIOPA suggested a variety of proposals including:

- reducing the number of small insurers subject to Solvency II by doubling the technical provision threshold for Solvency II to apply—from EUR 25 million to EUR 50 million—with European Union Member States being permitted to set the premium threshold between EUR 5 million and EUR 25 million;
 - introducing a simplified calculation of capital requirements for immaterial risks;
 - combining certain key functions;
 - requiring the ORSA only to be provided annually in respect of overall solvency needs and the continuous compliance with capital requirements and technical provisions; and
 - introducing greater flexibility in the frequency of the review of written policies (although a written remuneration policy is also recommended).
- **Long-term equity investments:** EIOPA challenged the Commission's approach to long-term equity investments, a new class of investments recently welcomed by the industry for its reduced capital charges for such investments. EIOPA noted in particular that its empirical analysis did not corroborate the decreased risk when an equity investment is held over a longer period of time. However, it made no express recommendations on this issue.
 - **Interest rate risk:** EIOPA previously provided unsolicited advice to the Commission on the calibration of the interest rate risk module, which was rejected by the Commission in 2018. EIOPA maintains its position in this consultation that the module insufficiently takes into account low and negative rates. Given the significant impact on capital requirements for some insurers, a phase-in period would be required.
 - **Group supervision:** EIOPA recognises that the current regulatory framework suffers from two key issues. First, that, in some cases, it is not very specific and second, that it relies on the *mutatis mutandis* application of rules written for solo (re)insurers in other places. EIOPA proposes to clarify a number of provisions in relation to group supervision, including scope of the group, particularly where the parent company is in a non-equivalent jurisdiction, and calculation of the group SCR where method 2 or a combination of method 1 and 2 is used.
 - **Cross-border supervision:** EIOPA proposed that, in complex situations, it may make recommendations to the relevant home and host supervisory authorities where agreement cannot be reached and that EIOPA may make such recommendations public if not followed within two months.

- **Minimum capital requirement (“MCR”):** EIOPA suggested that no change be made to the cap and floor set for the MCR. It has, however, suggested revision of the risk factors which are used in the calculation of the MCR and further clarity on the legal provisions regarding non-compliance with the MCR.
- **Ongoing assessment of Administrative, Management or Supervisory Body (“AMSB”) members and qualifying shareholders:** EIOPA proposed that “fit and proper” requirements be added to the assessment of AMSB membership and that ongoing financial supervision under Solvency II should include supervision of the system of governance. EIOPA also recommended that supervisory authorities should be enabled to require information from qualifying shareholders.

Conclusion

The proposals outlined above follow the ‘evolution not revolution’ model that the industry expected from EIOPA in this review. However, the proposals suggest that EIOPA is willing to suggest amendments under the built-in review mechanism to ensure greater harmonisation across the European Union Member States and to take account of problematic aspects of the framework, particularly in relation to macro-prudential analysis and the designs of certain calculations.

EIOPA is seeking responses on the proposals by 15 January 2020 with the expectation that it will provide the Commission with its final advice before the end of June 2020. Under the current timetable, the Commission is set to publish its report and identify any necessary legislative proposals by the end of 2020.

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Please do not hesitate to contact us with any questions.

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