EIOPA Consultation Paper on its second set of advice to the European Commission on the Solvency II Delegated Regulation

December 2017

OVERVIEW

On 6 November 2017 the European Insurance and Occupational Pensions Authority (**EIOPA**) released its Consultation Paper (**CP**) on its second set of advice to the European Commission (**EC**) on the Solvency II Review[1]. This follows on from an earlier CP and subsequent report[2] released by EIOPA in July and October respectively on its first set of advice on the Solvency II Review. Like that gone before, the second set of advice gives us an insight on what might change in the future within Solvency II.

The 438 page CP sets out EIOPA's proposed advice to the EC in a number of areas including:

- recalibration of standard parameters for premium and reserve risk
- volume measure for premium risk
- recalibration of mortality and longevity risk
- non-life catastrophe risk:
  - health catastrophe risk
  - man-made catastrophe risk
  - natural catastrophe risk
- interest rate risk
- market risk concentration
- currency risk at group level
- unrated debt
- unlisted equity
- strategic equity investments
- simplification of counterparty default risk
- treatment of exposure to CCPs and changes resulting from EMIR
- simplification of look-through approach
- look-through approach at group level
- loss absorbing capacity of deferred taxes
- risk margin
- comparison of own funds in insurance and banking sectors
- capital instruments only eligible as tier 1 up to 20% of tier 1

As was the case for the first set of advice, EIOPA's latest CP also includes draft impact assessments of the options it considered in developing its proposals.

The last date for stakeholders to provide feedback on the CP is 5 January 2018, and feedback must be provided using EIOPA's standard template. This timeline is shorter than the normal 3 month consultation period as EIOPA is expected to provide final advice to the EC on the proposed changes on 28 February 2018.

Milliman provided a summary of the CP released by EIOPA in July on its first set of advice on the Solvency II Review[3]. This paper provides an update to this by:

- outlining the key changes made to EIOPA's first set of advice in its final report in October;
- providing a summary of the proposed second set of advice in EIOPA's latest CP.

Updates to EIOPA's first set of advice

During the consultation period for its first set of advice on the Solvency II review, EIOPA received input from stakeholders to develop the ideas put forward in its initial CP. The final report does not reflect all of the suggestions received, however some updates have been made as set out below.

Simplified calculations – A proposal to allow undertakings to calculate their Solvency Capital Requirement (**SCR**) for a given sub-module without allowing for diversification benefits has now been introduced.

External credit ratings - For the proposal to permit the use of a single nominated external credit assessment institution (**ECAI**) when calculating the spread and concentration risk sub-

[1] https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-17-006_Consultation_Paper_on_Second_set_of_Advice_on_SII_DR_Review.pdf
[2] https://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-17-280_Final_report_on_First_set_of_Advice_on_SII_DR_Review.pdf

[3] http://www.milliman.com/insight/2017/Milliman-briefing-note-EIOPA-Consultation-Paper-on-its-first-set-of-advice-to-the-European-Commission-on-the-Solvency-II-Delegated-Regulation/

modules, EIOPA now clarifies that this ECAI must cover 80% (rather than "most") of the debt portfolio.

Treatment of guarantees - EIOPA clarifies that recognition of the risk mitigating effect of a partial guarantee for type 2 mortgage loans exposures in the counterparty default risk module should be subject to the partial guarantee meeting the requirements of Article 215(a) to (e), and not 215(f).

Risk-mitigation techniques - EIOPA states that its final advice to the EC in February 2018 will:

- provide further clarification on what constitutes exposure adjustments in relation to EIOPA's proposal to introduce an 'exposure adjustment' for rolling hedging strategies;
- set out EIOPA's position on whether or not adverse development covers should be recognised in the standard formula and, if yes, how.

Look-through approach - EIOPA now clarifies that the "related undertakings" that are not established for investment purposes and are not mostly used for investment activities are still subject to Article 84(4).

Undertaking Specific Parameters (USPs) - EIOPA states that it will further consider the methodologies proposed by stakeholders for USPs on lapse risk and provide its final advice to the EC by February 2018.

Loss absorbing capacity of deferred taxes - The analysis on loss absorbing capacity of deferred taxes has been updated. It is now based on data as at 31 December 2016 rather than data as at 1 January 2016.

EIOPA's first set of advice, including the above updates, will be considered by the EC as part of its review of the methods, assumptions and standard parameters underlying the SCR calculation using the standard formula. It will be supplemented by a second set of advice by end-February 2018, which is currently being consulted on and is the subject of this paper.

The EC's review is to be performed before December 2018, as required by recital 150 of the Delegated Regulation.

Recalibration of standard parameters for premium and reserve risk

Within the latest CP, EIOPA has assessed the need for a recalibration of the standard parameters for premium and reserve risk with respect to five non-life and health non-SLT lines of business (**LoBs**) including medical expense, worker compensation, credit and suretyship, legal expense, and assistance. These LoBs were selected based on the data available and data limitations discussed in the initial calibration. The data used in the latest assessment is considered by EIOPA to be sufficiently representative to support a recalibration.

The approach and methodology for assessing premium risk and reserve risk standard deviations is unchanged from the methodology used in the initial calibration, applied based on both a normal and lognormal parameterisation. In parallel, a calculation of the USP[4] for each undertaking was performed in order to back-test the results of the calibration and assess the number undertakings whose USP fell below the standard formula calibration.

CONCLUSION

A summary of EIOPA's conclusions are as follows:

PREMIUM RISK

LOB*	Indication: 2017 Data Analysis	Indication: USP Calculation	SF Parameter: Current	SF Parameter: Suggested Update
1	Increase	No Change	5.0%	6.0%
3	Increase	No Change	8.0%	9.6%
9	Increase	Increase	12.0%	19.9%
10	Increase	Decrease	7.0%	8.3%
11	Decrease	No Change	9.0%	6.4%

* LOB numbers correspond to: 1. Medical Expense; 3. Worker Compensation; 9. Credit and Suretyship; 10. Legal Expense; and 11. Assistance.

RESERVE RISK

LOB*	Indication: 2017 Data Analysis	Indication: USP Calculation	SF Parameter: Current	SF Parameter: Suggested Update
1	Increase	Increase	5.0%	6.6%
3	No Change	Increase	11.0%	11.0%
9	Decrease	Increase	19.0%	16.4%
10	Decrease	No Change	12.0%	5.5%
11	Increase	Increase	20.0%	22.0%

* LOB numbers correspond to: 1. Medical Expense; 3. Worker Compensation; 9. Credit and Suretyship; 10. Legal Expense; and 11. Assistance.

Further detail of the proposed changes can be found in this note.

Volume measure for premium risk

The underpinning principle for the assessment of the capital requirement for non-life underwriting risk refers to the uncertainty in the operating results of (re)insurance companies related to the existing business as well as to the new business to be written over the following twelve months (Article 105(2) of the Directive). This principle was addressed in the standard

[4] EIOPA used the prescribed legal methodologies described in Annex XVII of the Delegated Regulation.

formula throughout the sub-risk modules of premium and reserve risk, catastrophe risk and lapse risk.

CONCLUSION

EIOPAs proposals consider changes to the definition of FPfuture in setting the premium risk volume measure and clarification on the definition of the initial recognition date. Further detail of the proposed changes can be found in this note.

Recalibration of mortality and longevity risk

In this section, EIOPA advises on its selection of stochastic mortality models, the use of the Human Mortality Database (**HMD**) to calibrate the models and the derivation of stress factors.

Based on stakeholder feedback EIOPA has decided to use the Lee-Carter model and Cairns-Blake-Dowd model (**CBD**). The CBD model helps to compensate for the shortcomings of the Lee-Carter model, as it takes into account cohort effects, and the combination of the two models helps take into account model risk. EIOPA has decided to continue to rely on the HMD which has the advantage of consistently formatted data meaning procedures can be automated. Both models are estimated using the HMD for France, Germany, Netherlands, Italy, Poland, Spain and United Kingdom.

In order to derive a suitable distribution of future mortality, the Lee-Carter and CBD models, calibrated using HMD data, were used to project life expectancy for each age, country and model. The simulated life expectancy outcomes, using 5,000 random simulations, were then used to produce the 0.5^{th} and 99.5^{th} percentiles of life expectancy. A weighted average stress over all countries was calculated and then averaged over both models to take account of model error.

CONCLUSION

The results confirmed the appropriateness of the 20% longevity stress, but indicated an increase in the mortality stress to 25%. EIOPA asks stakeholders for further evidence on the appropriateness of the mortality stress factor.

Exploration of simplifications for sub-modules of the non-life catastrophe risk

Bearing in mind the need to strengthen a proportionate application of the requirements, EIOPA was asked to explore and propose methods and criteria for further simplifications for the sub-modules of the non-life catastrophe risk, in order to ensure that simple and practicable methodologies are provided for all standard formula calculations. In particular, EIOPA was asked to provide information on the relative significance of capital requirements related to these modules, assess whether the complexity is proportionate for small and medium-sized undertakings, and, where appropriate, develop suggestions for simpler structures for these modules.

Further details of the approach taken by EIOPA and its conclusions can be found in this note.

Interest rate risk

EIOPA considers the current relative approach (relative increases and decreases in spot yields for each term, with an absolute floor of 1% in the interest rate up stress, and nil stress for negative base yields in the interest rate down stress) inappropriate to measure interest rate risk in a low yield environment with negative interest rates and proposes to modify the methodology.

CONCULSION

EIOPA considered three alternatives to the current approach. One of these alternatives, the shifted approach, was not considered appropriate and so EIOPA recommends adopting one of the following:

The minimum shock approach – This method is based on the relative shocks as outlined in the current legislation. These relative shocks are applied to the yield curve, but with a specified minimum increase and maximum decrease. The suggested minimum is set to 200 basis points, and is phased out linearly between terms of 20 and 90 years. An absolute floor is also suggested for the interest rate down shock. This floor is equal to -2% for one year maturities, moving linearly to -1% at maturities of 20 years and above.

The combined approach – The features of the minimum shock approach are maintained under this methodology, but with an additional stress layered on top of this, the “affine stress”. The affine stress is calculated as the combined impact of the current relative stress approach and an additive shock. This additive shock is -1% in the down scenario and +1.4% in the up scenario for maturities up to 20 years. Between 20 and 90 years the additive shocks move linearly to zero.

Despite feedback from stakeholders that the ultimate forward rate (**UFR**) and long-term guarantee measures should be reviewed at the same time as the interest rate risk module, EIOPA has said it will continue to review the interest rate risk module in isolation.

EIOPA also stated that, despite feedback, it feels that the data set used to calibrate interest rate shocks, i.e. 17 years of historical risk-free curves, is appropriate.

Market risk concentration

Based on feedback from stakeholders, EIOPA will consider whether it is necessary to provide clarifications on the application of any of the current legal provisions and if so, what the appropriate form would be. Different assumptions are currently used by (re)insurers in the application of provisions, which stems from different understandings of:

- single name exposures for counterparties owned by the same public entity; and
- unavailability of a credit assessment by a nominated ECAI.

For the calculation of the risk factor for market risk concentration, EIOPA lays out two alternative approaches and illustrates these and the current Delegated Regulation through the treatment of four example Single Name Exposures (**SNE**). The approaches are as follows:

Reverse mapping - This involves mapping from solvency ratios to credit quality steps (**CQS**) consistent with Article 186. Table 1 below sets out an example of this mapping.

(Re)insurance undertakings subject to the Solvency II regime and without credit rating	
Solvency Position	**CQS**
MCR not met	5
SCR ratio>95%	5
95%<=SCR<100%	4
100%<=SCR<122%	3
122%<=SCR<175%	2
175%<=SCR<196%	1
SCR ratio >=196%	0
Other exposures without credit rating	
(re)insurance undertakings referred to in Article 186 (4)	3 / 4
Credit or Financial institution referred to in Article 186 (5)	3 / 4

Average risk factor – This approach involves calculating a weighted average risk factor instead of a weighted average CQS for a SNE based on a number of steps

CONCLUSION

EIOPA has stated that it will further analyse whether a change to the current treatment of “mixed” exposures in the Delegated Regulation is necessary, and if so Option 2 (the average risk approach) is considered the best alternative based on the analysis so far. In the case of such a change, the same provisions would be applied to Article 199(4) to (7) of the Delegated Regulation, which use the same terminology as Article 186(2) to (5).

Currency risk at group level

EIOPA addressed options to hedge currency risk for Group SCR calculations. Currently groups with exposures to many different currencies have a high group currency capital charge because the group must shock all foreign currencies (other than the one used to prepare consolidated financial statements).

EIOPA put forward two possible approaches to overcome this excessive currency risk exposure:

- Groups can exclude sufficient assets to cover the local MCRs from their group currency risk calculations. However, there are drawbacks to this approach including the limited benefit to groups with significant foreign currency exposures.
- Groups can select a “local” currency for the currency risk module which is different to the reporting currency used in their consolidated accounts. The choice of local currency would need to be justified based on objective criteria.

CONCLUSION

EIOPA has proposed the second of these two options as the best modification to the current methodology.

Unrated debt

In this section, EIOPA considers how insurers should treat bonds and loans which have not been assigned a credit rating by a nominated ECAI. EIOPA proposes that a potential rating could be obtained via:

- internal assessment by insurers; or
- where a bank and insurers co-invest, an approved internal model of the bank.

Unrated debt is eligible for either approach if it is issued by corporates from any sector except financial and infrastructure. The former is covered in the Delegated Regulation and the latter is subject to separate EIOPA advice.

The total amount of unrated debt assigned a CQS using these methods should not exceed 5% of all investments.

Internal Assessment Approach

The issuing company cannot be from the same group as the insurer and only debt from senior exposures is allowed.

Any eligible unrated debt can be assigned to CQS 2 if certain conditions, outlined in the CP, are met which demonstrate that the riskiness of the debt is in line with CQS 2.

The insurer shall use its internal processes to distinguish high and low credit risk debt and produce an assessment of any unrated debt. In the CP EIOPA outlines the criteria that it expects to be met by this assessment, and indicates the possibility of further requirements in the future.

Approved Internal Model Approach

Where a bank and an insurer have co-invested in unrated debt the insurer can refer to the bank, if it has an approved internal model, for the assessment and underwriting of the credit risk and derivation of the CQS of the debt. The CP outlines criteria regarding the bank's underwriting process, transparency and the avoidance of risk selection that must be satisfied before this approach may be used.

A mapping of the probability of default produced by the model to the correct CQS may then carried out based on a pre-defined table.

The bank should maintain at least a 50% exposure to the co-invested unrated debt.

When using this approach the insurer still remains responsible for complying with relevant requirements and questioning any results produced by the internal model.

CONCLUSION

For both of the approaches above, EIOPA has set out a number of areas where additional input from stakeholders would be useful. It describes the approved internal model approach as an 'alternative' to the internal assessment approach, however it is currently unclear whether it is proposing to introduce one or both of these options. In any case, it expresses a number of material concerns in relation to the approved internal model approach.

Unlisted equity

Within this section, EIOPA considers whether investments in the equity of companies that are not listed and are based in the EU/EEA, either directly or otherwise, should be considered as type 1 equities provided that certain conditions are met. Unlisted equities are currently treated as type 2 equities, despite the fact that their risk profile may be similar to type 1 equities.

EIOPA suggests the use of a look-through approach (in the case of indirect investments) and the application of the following criteria to determine assets that qualify to be treated as type 1 equities.

Underlying investments – Investment must be in the common equity of companies that are unlisted, established in the EU or EEA with the majority of its revenue from EEA or OECD countries. The companies must have the majority of their staff in the EU/EEA and have been larger than a 'Small-Sized Enterprise' for at least the last 3 years.

Investment vehicle – Eligible private equity (**PE)** funds must be closed-ended, with the fund intending to hold investments over a period of several years. EIOPA is considering whether the fund should be allowed to use a moderate amount of leverage.

Diversification – Due to the significant differences in individual PE fund performance and the difficulty of exiting funds, EIOPA suggests that insurers should spread PE investment across at least 25 independent PE fund managers.

Transparency – For a PE investment, the insurer will need to ensure that the necessary information for the assessment of fund manager performance is available. Independent annual valuations of the portfolio companies must be performed.

Own risk management – When investing in PE or unlisted equity, EIOPA considers that the insurer should perform proper due diligence and liquidity risk management, regularly monitor performance and have sufficient expertise to invest in unlisted companies.

LOOK-THROUGH CRITERION

EIOPA is exploring two possible look-through criteria, which are based on measurements of the fundamental risk of the underlying companies:

Beta method - EIOPA details a variation on the "traditional" beta methods, as they require various market information likely to be unavailable for unlisted equities. If the beta is below the specified threshold, the asset is eligible to be treated as a type 1 equity.

To ensure the model is sufficiently accurate, the portfolio must contain 10 or more unlisted equity investments. Financial companies cannot be included and must use the type 2 charge.

Stressed loss approach - This method tests for eligibility based on the relative portfolio risk as a weighted average of the relative company risks. It assumes that a significant degree of diversification across individual companies can be achieved by investing in a number of PE funds.

This method is easy to implement and simply requires the industry sector and financial leverage of each unlisted company. However, due to the need for diversification it can only be applied to unlisted companies in sectors where the largest allocation does not represent more than 5% of the total exposure to the sector. If this is not the case then the type 2 charge must be applied.

CONCLUSION

EIOPA proposes that unlisted equities can be treated as type 1 equities if they satisfy the criteria described above. For companies from the sectors not listed in the look-through criterion, the capital charge for type 2 equities should be applied.

Strategic equity investments

Article 171 of the Solvency II Delegated Acts outlines specific factors required for equity investments to be considered strategic in nature, and to benefit from a reduced equity stress within the standard formula. In this section EIOPA responds to a request for information relating to insurers' approaches to evidencing that these criteria are met and presents the results of a survey sent to NSAs to gather information on this subject. The survey outlines approaches the NSAs have seen insurers take, as well as the methods by which they validate insurers' strategic equity investments.

Finally, EIOPA provides a quantitative analysis of the €155 billion of strategic equity investments located on EIOPA's database.

CONCLUSION

EIOPA is not proposing any changes to the current approach but simply providing additional information to interested stakeholders.

Simplification of counterparty default risk module

In this section, EIOPA explores the complexity of the calculation of the counterparty default risk module and whether there is scope to develop simpler structures for this module.

Based on the gross SCR for counterparty default risk relative to the Basic SCR (**BSCR**), on average this risk is significant for all types of undertakings but not a main risk. However it is important to note that, there is a great variance in the relative significance of the counterparty default risk module across undertakings.

EIOPA also notes that:

- the relative significance of the counterparty default risk module is higher for smaller undertakings; and
- the relative significance of the counterparty default risk module seems larger for non-life undertakings than for life undertakings.

EIOPA has calculated that 14% of all undertakings use one or more of the simplifications for the counterparty default risk module. There is concern that the simplifications may not be sufficiently 'simple', as only 7% of small undertakings use simplifications whereas medium-sized and large undertakings use the simplifications to a greater extent. This could imply that the simplifications do not sufficiently reduce the complexity of the calculation to achieve their intended purpose.

CONCLUSION

EIOPA has proposed simplifications and clarifications to the following items based on stakeholder feedback:

- Treatment of derivatives in the counterparty default risk module
- Definition of a financial risk-mitigation technique
- Calculation of the risk-mitigating effect of derivatives
- Calculation of the LGD on derivatives
- Clarification of the calculation of the hypothetical SCR
- Simplified calculation of LGD on reinsurance arrangements
- Simplified calculation for type 1 exposures
- Clarification of type 1 loss distribution
- Simplified calculation for the risk-mitigating effect of reinsurance arrangements
- Adjustment of simplifications for reinsurance recoverables
- Simplified calculation for LGD in grouping SNEs

The CP provides more detail on each of these.

Treatment of exposure to qualifying central counterparties (CCPs) and changes resulting from EMIR

In this section, EIOPA responds to the call for advice to develop an approach for qualifying central counterparties (**CCP**) within the counterparty default risk module, with a view to ensuring consistency with the Capital Requirements Regulation (**CRR**) and other regulation within the banking sector. This call for advice reflects the European Markets Infrastructure Regulation (**EMIR**), which requires certain type of derivatives to be cleared through an authorised CCP, making exposures to CCPs much more relevant for insurers.

Currently no insurer is believed to be a member of a CCP. Exposures to CCPs only arise where an insurer uses the services of a member to gain access to the CCP, known as 'indirect clearing'. Within the CRR, the credit risk calibration differs depending on whether the derivative in question has been indirectly cleared, or is part of a 'bilateral transaction', where the two parties deal directly with one another. EIOPA considers that it is sensible for insurance regulation to differentiate derivatives in the same manner.

EIOPA notes that if assets posted as collateral are held within a bankruptcy-remote entity (i.e. a legally separate entity from the

CCP and the clearing member), then the exposure will not attract a counterparty default risk capital charge.

The paper then considers the derivation of the probability of default and the recovery rate for indirectly cleared derivative exposures. Two possible approaches are proposed:

Option 1 - With the exposure considered on a stand-alone basis (rather than as part of the total portfolio), the probability of default and the recovery rate should be set so that the risk charge for the exposure is a fixed percentage of the risk charge for an otherwise identical bilateral transaction with a counterparty of credit quality step 2 (typically an 'A'-rated counterparty). If the derivative transaction meets the conditions set out in Article 305 (2) of the CRR, the fixed percentage should be 4%. If only the conditions in Article 305 (3) are met, the fixed percentage should be 8%.

With this option, there is no impact on the calculation of LGD within the standard formula.

Option 2 - Where the derivative transaction meets the conditions set out in Article 305 (2) of the CRR, the probability of default should be set to that for 'AAA'-rated exposures and the recovery rate to 50%. Where only the conditions in Article 305 (3) are met, the probability of default should be set to that for 'AA'-rated exposures and the recovery rate to 50%.

When using this option the LGD for the derivative should be altered (EIOPA provides the replacement formula in the paper).

CONCLUSION

It is currently unclear if EIOPA considers either approach as preferable, as it acknowledges pros and cons for both. For example it notes that calibrations under Option 2 may be inconsistent with those used in the banking sector, however the resulting low capital requirements are in line with banking regulation and this approach also acknowledges the limitations of calibrations based on historical evidence.

Simplification of look-through

In this section, EIOPA considers the appropriateness of the simplified look-through approach permitted for the SCR calculation where a full look-through of a company's collective and other fund-type investments is not available.

CONCLUSION

Currently, the simplified approach can only be applied to up to 20% of the undertaking's total assets. EIOPA proposes to maintain this threshold, and provides the results of the quantitative analysis that supports this. EIOPA does however propose that index- and unit-linked products should be excluded from this threshold, provided that either:

- they do not significantly contribute to the SCR (i.e. insurance products without significant guarantees or policyholder options); or
- the change in the value of assets does not significantly affect the available own funds (due to future profits).

EIOPA does not elaborate on the criterion above in this CP. Therefore it is not clear whether index- and unit-linked products with a large negative Best Estimate Liability (BEL) would meet this criterion, particularly where the change in value of the BEL under stress would lead to a significant contribution to the SCR.

The look-through approach should still be applied to the assets that meet this criterion but where a significant part of the market risk is transferred to policyholders (i.e. there are no material financial guarantees), EIOPA proposes that the simplified approach may be used without limitation.

Currently, the use of the target asset allocation is permitted for collective investment schemes (or investment funds) where the actual asset allocation is not available. EIOPA proposes to allow firms the further option of using the fund's last reported asset allocation, provided the underlying assets are (and will be) managed strictly according to that allocation.

EIOPA also proposes to allow the prudent use of data "groupings" even when the target asset allocation or last reported asset allocation is not available at the necessary level of granularity to calculate the relevant SCR scenarios. EIOPA provides the example that if it is impractical to obtain credit ratings at single exposure level, an average CQS based on the investment fund's mandate may be appropriate, provided it can be demonstrated that it is prudent.

Finally, EIOPA recommends an additional article to be included in the Delegated Regulation. This imposes the requirement to assess the nature, scale and complexity of the relevant risks, and whether these are in line with the relevant assumptions underlying the simplified calculation. This is intended to avoid misuse of the simplified approach and prohibits its use where the error introduced may lead to a material understatement of the SCR.

Look-through approach at group level

In this section EIOPA considers how the look-through approach should be applied at group level, particularly for investments in 'related' collective investment undertakings (for instance where the group holds more than a 20% stake in the undertaking). Currently, for related undertakings, look-through is applied in different cases at group level than it is at solo level. Some local markets have different approaches, or different assessments of whether an investment is 'related' or otherwise, leading to divergence at European level.

CONCLUSION

EIOPA proposes two options, and asks for feedback from stakeholders:

- Maintain the current Delegated Regulations and provide more guidance to supervisors as to when they should consider investments as related.
- Recommend a change to the Delegated Regulations so that related undertakings are treated the same at group level as they are at solo level.

Loss absorbing capacity of deferred taxes

EIOPA has considered issues around different methods applied to the calculation of the loss absorbing capacity of deferred taxes (**LACDT**) across companies and countries, and the extent to which it can lead to differences in the capital requirements.

EIOPA has found that NSAs have similar approaches for the portion of LACDT where utilisation is demonstrated by a net deferred tax liability (**DTL**) on the balance sheet. However, when examining the remaining portion of LACDT, which is demonstrated by likely future profits, EIOPA has found that NSAs have varying approaches, with a wide range of assumptions and outcomes being observed for similar companies.

EIOPA seeks to achieve convergence in the calculation of LACDT and, going forward, will consider suitable good practices to ensure such convergence.

EIOPA outlines three concerns with the current calculation practices:

- The uncertainty about future profits for utilisation of notional deferred tax assets (**DTA**);
- The complexity involved in projections of future profits; and
- An uneven playing field because of the wide range of judgement involved in the likely utilisation of notional DTA.

In its advice, EIOPA has highlighted several key principles to bring about supervisory convergence, and to address these concerns, which include:

- role of compliance with the MCR and SCR after shock loss;
- future profits stemming from new business (projection assumptions, projection horizon of future profits and projection horizon of new business sales);
- future profits from returns on assets;
- ruture management actions;
- role of the System of Governance; and
- supervisory reporting and disclosure.

In addition, EIOPA suggests a simplification to the calculation of LACDT in order to reduce the complexity surrounding the calculation.

Undertakings that wish to use such a simplified calculation would have to demonstrate that the taxable economic profits become fiscal profits at the right times for the utilisation of the post-shock DTA.

CONCLUSION

EIOPA would appreciate feedback on the Key Principles and proposed simplified formula from (re)insurance undertakings, both on the practical implementation of these principles and the reasonableness of the thresholds set within them.

Risk margin

In this section EIOPA considered changes to the cost of capital (**CoC**) rate used in the calculation of the risk margin (**RM**). EIOPA lists various stakeholder suggestions on methods to set the CoC rate, along with its assessment of each of these. It also lists a number of stakeholder suggestions on various changes to the calculation of the RM itself, such as to allow for the hedgeability of longevity risk or to include market risk in the reference undertaking. However, EIOPA did not consider any of these suggestions further.

The main focus of EIOPA's work in relation to the RM was to provide advice on revising the CoC rate.

EIOPA followed the same approach that CEIOPS applied in its technical advice on the RM of 2009. In particular, it has been assumed that the CoC is equal to the cost of equity, calculated with the capital asset pricing model (**CAPM**), which includes:

- an Equity Risk Premium, for which historical return models and dividend discount models were analysed, with the historic return models ultimately chosen; and
- a Beta factor, which reflects the insurance sector stock performance compared to that of the wider market.

A multiplicative adjustment of 0.8 was also made, to allow for economic aspects not reflected in the CAPM estimation of the CoC.

EIOPA has provided some statistics on the size of the RM relative to other items in the first three quarters of 2016. For example, the ratio of RM to SCR at European level is 26%.

Interestingly, this ratio is approximately 40% in Ireland and 20% in the UK. In Ireland, there is also a big difference between life (50%) and non-life (15%) insurers. This is not really the case in the UK, where there is only a small difference between life and non-life.

CONCLUSION

EIOPA has recommended that the current CoC rate of 6% should not be changed. This recommendation is based on the results of calculations carried out which suggest CoC is in the range of 6% to 8%.

Comparison of own funds in insurance and banking sectors

In its discussion paper issued in December 2016[5], EIOPA set out an analysis of the differences between the classification and treatment of comparable own fund items under the banking sector's Capital Requirement Regulation (**CRR**) and the Delegated Regulation. The three main points of difference identified in that analysis were:

- the operation of the Principal Loss Absorbing Mechanism (**PLAM**) and requirements for further write-downs;
- the potential for tax liability arising from the write-down of restricted tier 1 (**rT1**) instruments; and
- regulatory and tax calls on rT1 instruments within five years of their issue.

In this CP, EIOPA considers these differences further and assesses the justification for amending the Delegated Regulation to align with the CRR.

CONCLUSION

In brief, the following changes to the Delegated Regulation are proposed:

- Permit partial write-down of rT1 instruments on a straight-line basis, provided that neither the MCR nor 75% SCR coverage are breached;
- Further write-down is required only in the event of a worsening in the SCR coverage following an initial breach, with requirements around regular SCR coverage recalculation;
- Permit requests for waivers from compulsory write-down if such a write-down would lead to a tax liability arising; and
- Permit redemption of an own fund instrument within 5 years of its issue, without replacement, in the event of a tax or regulatory call (significant and unforeseeable change in regulation or fiscal policy).

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

Paid-in subordinated mutual member accounts, paid-in preference shares and the related share premium account, and paid-in subordinated liabilities are deemed to fulfil the tier 1 eligibility criteria. However, these items are restricted to a quantitative limit of 20% of the total tier 1 amount. These instruments are referred to in the CP as restricted tier 1 (**rT1**) or "hybrid" instruments.

If the 20% limit is removed, undertakings could comply with the requirement for at least 50% of the SCR to be presented by tier 1 own funds by holding more rT1 capital and equity-like capital than at present, weakening the ability of Solvency II to deliver protection to policy holders and beneficiaries at the 1-in-200 level.

In this CP, EIOPA responds to the feedback from respondents to the EIOPA-CP-16/008 discussion paper and presents two options and its views on them:

- To retain the limit in its current form; or
- To remove it and strengthen the quality of rT1 instruments.

In the latter case, EIOPA considers whether any amendments to the Delegated Regulation would be needed with respect to the tier 1 eligibility criteria to mitigate any loss in capital quality.

Option 1 - EIOPA believes that if the limit was removed, it would necessitate action to mitigate the resulting effect of lowering the quality of tier 1 capital. However, it argues that the changes to the features required of rT1 instruments, described in Option 2, would not be able to fully mitigate the effect on tier 1 own funds of removing the limit, and thereby deliver the same quality of own funds as before any change. As such, EIOPA proposes that the limit should be retained.

Option 2 - If the limit is removed, EIOPA proposes that the impact on tier 1 capital quality can be partly mitigated by amending Article 71 of the Delegated Regulation by:

- Improving the permanence of rT1 instruments;

[5] https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-16-008_Discussion_Paper_on_SII_DR_SCR_Review.pdf

- Improving the loss absorbency of rT1 instruments through a full write down on breach of any of the mandatory trigger events; and
- Strengthening the mandatory trigger events at which the rT1 instruments provide loss absorbency.

CONCLUSION

EIOPA is proposing no change to the 20% limit (option 1), however it sets out some proposals to limit the impact on the quality of tier 1 capital if a decision is ultimately made to change the limit (option 2).

Summary

In summary, this CP covers a wide range of proposed changes to the current Solvency II requirements. Some of the key proposals include:

- an increase in the calibration of the standard formula mortality risk capital charge from 15% to 25%;
- changes to the methodology underlying the interest rate risk capital charge to take account of the low interest rate environment;
- simplifications to the application of the 'look through' approach for the purposes of the SCR calculation;
- a proposal to keep the cost of capital rate used in the calculation of the risk margin unchanged at 6%; and
- changes to the standard formula factors for the standard deviation of premium and reserve risk for some non-life lines of business and changes to the volume measure for premium risk.

However it remains to be seen how stakeholders will react to these changes through the consultation process. Final Advice is expected to be issued by EIOPA at the end of February 2018.

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