MILLIMAN BRIEFING NOTE

EIOPA Final Report on its second set of advice to the European Commission on the Solvency II Delegated Regulation

March 2018

Overview

On 28 February 2018, the European Insurance and Occupational Pensions Authority (**EIOPA**) released a final report outlining its second set of advice to the European Commission (**EC**) on the Solvency II Delegated Regulation[1] (**BoS-18/075**).

This report follows on from a Consultation Paper (the **CP,** or **CP-17-006**) in November 2017 in which EIOPA set out its proposed second set of advice on the Solvency II Delegated Regulation for stakeholders to provide feedback on. After having reviewed the comments from stakeholders, EIOPA has modified its advice where appropriate in this report.

An earlier CP and subsequent final report released by EIOPA in July (**CP-17/004**) and October 2017 (**BoS-17/280**) respectively shared EIOPA's first set of advice on the Review of the Solvency Capital Requirement Standard Formula Under Solvency II (Solvency II Review).

Milliman provided summaries of the CPs released by EIOPA on its first and second sets of advice on the Solvency II Review in July[2] and December 2017[3] respectively, the second summary also provided an update for the final proposal on the first set of advice.

The final report containing EIOPA's second set of advice is 611 pages in length and advises on areas covered in the CP-17-006, including:

- recalibration of standard parameters for premium and reserve risk;
- volume measure for premium risk;
- recalibration of mortality and longevity risk;
- catastrophe risk (health, man-made and natural);
- 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 central counterparties (**CCPs**) and changes resulting from the European Market Infrastructure Regulation (**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.
- Article 209(3): Allowed adjustments to risk mitigation techniques (**RMT**);
- undertaking specific parameters (USP) for lapse risk; and
- recognition of adverse development covers.

EIOPA also carried out an impact assessment of the proposed changes.

Several of the proposals in the corresponding CP generated feedback from stakeholders. As such, in this update we will summarise the key feedback that was received by EIOPA, and the impact, if any, that it has had on the proposals made in the CP.

EIOPA's first and second sets of advice to the EC are intended to provide technical guidance and recommendations as part of the EC's ongoing review into the methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement (**SCR**) with the standard formula (**SF**).

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

[1] https://eiopa.europa.eu/Publications/Consultations/EIOPA-18-075-EIOPA_Second_set_of_Advice_on_SII_DR_Review.pdf
[2] 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/
[3] http://uk.milliman.com/insight/2017/EIOPA-Consultation-Paper-on-its-second-set-of-advice-to-the-European-Commission-on-the-Solvency-II-Delegated-Regulation/

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there is still uncertainty over the effective date of any changes should the EC agree to the recommendations from EIOPA.

In addition, the Delegated Regulation also foresees the review of the Solvency II framework as a whole, including the treatment of long-term guarantees (**LTGs**), to be completed by 2021.

Summary

The recommendations proposed by EIOPA are intended to reflect developments in the insurance sector and the wider environment. The final set of advice proposed to the EC contains a mixture of revised calibrations, simplifications, technical corrections and, in certain cases, proposals for achieving greater supervisory convergence.

Some of the highlights from the second set of advice to the EC are:

- EIOPA proposes revised calibrations in a number of areas (such as natural catastrophe risks and assistance and medical expenses) arising due to the availability of more recent data;
- Regarding the calculation of interest rate risk, the existing approach is described as not being effective in a low yield environment and does not cater for negative interest rates. As such, EIOPA recommends new calibrations to correct this unintended technical inconsistency. It proposes that a new methodology is used for deriving the stressed interest rates based on a "relative shift" approach. The impact of this update is likely to be material (EIOPA quotes an average reduction in solvency ratio of 14%) and as such proposes that the approach is phased in over the next 3 years;
- In other areas, the analyses of recent developments in the insurance sector do not provide for sufficient evidence to revise calibrations. In particular:
  - EIOPA recommends that the required longevity and the mortality stress factors remain unchanged at 20% and 15% respectively; and
  - EIOPA does not recommend a change to the 6% rate for cost-of-capital (**CoC**) used in the risk margin calculation;
- With respect to the treatment of unrated debt and unlisted equity, EIOPA advises that objective criteria (such as financial ratios) should be used as criteria to determine when these asset classes can be given the same treatment as rated debt and listed equity; and
- A set of 'key principles' have been developed by EIOPA, designed to help bring about convergence on the treatment of the loss absorbing capacity of deferred taxes (**LACDT**) demonstrated by future profits.

Further information on these topics, and all other areas covered in the second set of advice, is provided below.

Recalibration of standard parameters for premium and reserve risk

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 (**LoB**). These were selected based on the data available and data limitations are discussed in the initial calibration.

FEEDBACK

Some stakeholders advocated for the application of country specific volatility (rather than applying the same factors across Europe for a given LOB) so that differences in national markets would not be disregarded.

In addition, stakeholders wanted clarification as to whether a change in the standard parameters would have an impact on insurers using undertaking specific parameters (**USP**), and also whether any potential recalibration of standard parameters would be subject to a transitional period.

Finally, the data and methodology used by EIOPA in the recalibration assessment was questioned by some stakeholders.

CONCLUSION

In response to this feedback, EIOPA stated that the scope of the call for advice was focused on the standard parameters of the non-life premium and reserve risk. As such, it did not consider country specific parameters.

Secondly, USP are meant to derive volatility parameters in accordance with the risk profile of undertakings. As a change in the standard parameter has no impact on the risk profile of a given undertaking, it cannot result in the withdrawal of the USP approval and a return to a standard parameter. The only way insurers using USP could be impacted is where the undertaking have less than 10 years of data and as such use a credibility factor. Then a change in the level of the standard parameters would impact the USP figure.

As summarised in this note, the approach and methodology for assessing premium risk and reserve risk standard deviations is unchanged from the methodology used in the initial calibration.

The data used in the assessment was considered by EIOPA to be sufficiently representative to support a recalibration, but, as stated above, the industry raised some concerns. As a consequence, EIOPA has deemed it necessary to amend its calibration for some selected lines of business in the final advice.

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EIOPA has performed an impact analysis of the changes and, given the outcome, does not consider a transitional period to be necessary for implementing these changes.

A summary of EIOPA's conclusions are as follows:

LOB*	SF Premium Risk		SF Reserve Risk	
	Current Parameter	Updated Parameter	Current Parameter	Updated Parameter
1	5.0%	5.0%	5.0%	5.7%
3	8.0%	9.6%	11.0%	11.0%
9	12.0%	19.0%	19.0%	17.2%
10	7.0%	8.3%	12.0%	5.5%
11	9.0%	6.4%	20.0%	22.0%

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

Volume measure for premium risk

The EC has requested a reassessment of the continued appropriateness of the definition of the volume measure for premium risk at the same time as reviewing the calibration of the standard parameters for non-life premium risk. In particular, the definition of the component FP_{future} of the volume measure for premium risk was challenged.

EIOPA provided initial suggestions for a potential changes in the definition of FP_{future}, in the CP, which we summarised in this note.

FEEDBACK

The inclusion of FP_{future} and possible changes of its definition in the quantification of the volume measure for premium risk is a sensitive topic within the industry for undertakings using the standard formula.

In their feedback, the views of stakeholders were split on the options EIOPA had presented in the CP to define the volume measure (and in particular FP_{future}) with some stakeholders offering alternative definitions.

Several stakeholder stated that they believe that, especially for annual contracts, the volume measure should not go beyond a 1-year timeframe.

CONCLUSION

Based on the feedback received, EIOPA has opted to maintain the status-quo for 1-year contracts and enhance the approach for multi-year contracts.

The final advice from EIOPA is to change the definition of FP_{future} as follows (the definitions for other components of the volume measure for premium risk will remain unaltered):

- For 1-year contracts, the expected present value of premiums to be earned by the insurance and reinsurance undertaking in the a segments for contracts where the initial recognition date falls in the following 12 months but excluding the premiums to be earned during the 12 months after the initial recognition date; and
- For multi-year contracts, 30% of the expected present value of premiums to be earned by the insurance and reinsurance undertaking in the segment s, after the following 12 months, for contracts where the initial recognition date falls in the following 12 months.

EIOPA expects that the impact for undertakings writing multi-year contracts would be limited.

Recalibration of mortality and longevity risks

In the CP on its second set of advice, EIOPA proposed maintaining the 20% reduction to mortality rates required in the standard formula approach to calculating the Solvency Capital Requirement (the **SF SCR**) where a decrease in mortality rates leads to an increase in the value of insurance liabilities (longevity risk). However, it proposed requiring an increase of 25% (rather than 15%) to mortality rates in the calculation of the SF SCR where an increase in mortality rates leads to an increase in the value of insurance liabilities (mortality risk).

In addition, EIOPA advised on its selection of stochastic mortality models (it decided to use the Lee-Carter model and Cairns-Blake-Dowd (**CBD**) model and use the Human Mortality Database (**HMD**) to calibrate the models. These were used by EIOPA to derive a suitable distribution of future mortality to project life expectancy.

FEEDBACK

Most stakeholders expressed that the increase to the mortality stress would represent too extreme an event for contracts with significantly shorter durations than whole-of-life.

Stakeholders had observed that the proposal to use a 25% mortality risk stress was derived based on consideration of changes in expectations of life, and the conversion of this into an equivalent instantaneous shock over 12 months.

However, uncertainty increases over time. Therefore, where contracts have significantly shorter durations than whole of life, a shock deemed to be equivalent to a 1-in-200 year change to expectations of life will overstate the shock that is appropriate to such contracts.

Regarding the proposed change to the longevity risk stress, most stakeholders agreed with EIOPA's assessment to maintain the current stress at a 20% reduction to mortality rates.

In addition, most stakeholders agreed with the use of the Lee-Carter model and CBD model. With respect to the use of the

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HMD, the majority of stakeholders recognised that whilst it is a good basis and easily accessible, they would have liked EIOPA to have collected information from insurance undertakings, given that mortality and longevity risks of insured populations may differ from the general population.

CONCLUSION

After taking into consideration the views of stakeholders, in its final advice EIOPA recommends that the required longevity and the mortality stress factors remain unchanged at 20% and 15% respectively, and continue to be applied for all ages and terms.

EIOPA also defended the use of the HMD, stating that it is publically available, reliable and replicable and stated that it aimed to limit the burden on insurance undertakings (given the granularity of information that was required).

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

EIOPA was asked to explore and to 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 were summarised in this note.

FEEDBACK

The proposed advice from EIOPA for each sub-module was well received by stakeholders. In particular, stakeholders:

- Felt that many of the proposed changes looked reasonable and welcomed the simplifications of the risk sub-modules, but in certain cases questioned whether they were too conservative;
- Offered potential improvements to EIOPA's advice; and
- Requested additional guidance and clarification on certain definitions.

CONCLUSION

A summary of EIOPA's final conclusions for each sub-module are as follows:

HEALTH: MASS-ACCIDENT RISK

In its final set of advice, EIOPA recommends that the Mass Accident event type "temporary disability that lasts 10 years" be deleted. EIOPA expects that the majority of risks currently modelled within this category would migrate to the temporary disability (less than one year) bucket, with the remainder being modelled as permanent disability.

EIOPA's advice is to increase the Mass Accident parameters for temporary disability (less than one year) and permanent disability from 13.5% and 1.5%, respectively, to 16.5% and 3.5%, respectively.

HEALTH: ACCIDENT CONCENTRATION RISK

EIOPA considered two options for the simplification of the accident concentration sub-module, suggesting the following changes to Article 162 (3) of the Delegated Regulation:

- For the 'largest number of persons': it was considered to use the biggest collective contract as a proxy, where this type of contract is part of an undertaking's portfolio; and
- For 'the persons that are working in the same building': it was considered to use a major hit to the headquarters of the undertaking.

The two main proposals for simplification turned out to not be appropriate in a number of cases. Therefore, no simplification is proposed by EIOPA for this calculation.

HEALTH: PANDEMIC RISK

EIOPA has also recommended that National Supervisory Authorities (**NSAs**) individually set maximum unit claim costs which should be used for hospitalisation, consultation and 'no formal medical care' costs, under the Pandemic risk sub-module.

MAN-MADE: FIRE RISK

Recognising that there are difficulties with the current methodology, EIOPA recommends that a simplified calculation be made available to allow for a reduction in the number of per-address exposures considered, namely the top five exposures per risk type (residential, commercial, industrial) in the portfolio. This approach assumes that the largest concentration of exposure will have one of the largest five exposures as a central point, subject to an underpin based on the relevant market share of the undertaking.

MAN-MADE: MARINE RISK

EIOPA recommends a change to Article 130 of the Delegated Regulations to replace the 'tanker' scenario with 'vessel' type to allow for the SCR to arise from any source. EIOPA also

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proposes to introduce a threshold such that vessels with a hull value less than EUR 250,000 are not included in the scenario.

MAN-MADE: MOTOR VEHICLE LIABILITY RISK

EIOPA regards its Q&A process on the Delegated Regulation[4] as sufficient to clarify the application of the motor third-party liability (**MTPL**) standard formula approach. Further, EIOPA proposes to investigate the potential introduction of a parameter reflecting an undertaking specific split of the number of contracts between limited and unlimited cover, rather than the currently uniformly imposed split of 5% unlimited and 95% limited.

MAN-MADE: IDENTIFICATION OF THE LARGEST MAN-MADE CATASTROPHE EXPOSURES ON GROSS AGAINST NET OF REINSURANCE BASIS RISK SUB-MODULE

EIOPA recommends that the identification of the largest risk exposures within the Marine, Fire and Aviation (**MFA**) risk sub-modules are altered to be carried out net of reinsurance (as opposed to the current gross of reinsurance basis) for the calculation of the SCR when reinsurance cover alters the relative ranking of the exposure within the undertaking's portfolio. However, in cases where distortion persists, the undertaking should continue to identify the largest exposures on the basis of gross exposure and highlight the issue through their Own Risk and Solvency Assessment (**ORSA**).

EIOPA notes that this change would also affect the calculation of the risk-mitigating effect in the counterparty default risk module. Therefore the calculation of the hypothetical SCR for MFA risks referred to in Article 196(a) should also be carried out on the basis of the identification of the largest risk exposure net of reinsurance. With respect to Fire risk (see above) and in order to limit the extent of complexity introduced, EIOPA recommends that the hypothetical SCR be calculated using the new recommended simplification.

NATURAL: SIMPLIFICATION:

EIOPA recommends the addition of an optional simplification for undertakings with immaterial exposure to natural catastrophes. Option 5 (of 6 options considered) was assessed to be most appropriate as it meets the conditions in Article 88 of the Delegated Regulation, is considered easy to follow and is obvious without the necessity of additional explanations. The optional simplification allows for the mapping of non-allocated exposure to the Catastrophe Risk Evaluation and Standardising Target Accumulations (**CRESTA**) zone with the highest zonal weight.

NATURAL: RECALIBRATION OF SCENARIOS:

Having assessed the recommendations of the Catastrophe risk work-stream (**CAT WS**), after having consulted with national insurance associations, and after accounting for cross-border consistencies; EIOPA recommends the following recalibrations of the scenario specific risk factors by peril:

COUNTRY	PERIL	CURRENT SCENARIO SPECIFIC RISK FACTORS	RECOMMENDED SCENARIO SPECIFIC RISK FACTORS
AUSTRIA	WS	0.080%	0.060%
CZECH REPUBLIC	WS	0.030%	0.040%
GERMANY	WS	0.090%	0.070%
FINLAND	WS	NEW SCENARIO	0.040%
HUNGARY	WS	NEW SCENARIO	0.020%
IRELAND	WS	0.200%	0.220%
LITHUANIA	WS	0.100%	0.120%
SWEDEN	WS	0.090%	0.085%
SLOVENIA	WS	NEW SCENARIO	0.040%
SPAIN	WS	0.030%	0.010%
SWITZERLAND	WS	0.080%	0.080%
GREECE	EQ	1.850%	1.750%
ITALY	EQ	0.800%	0.770%
SLOVAKIA	EQ	0.150%	0.160%
FRANCE	FL	0.100%	0.120%
HUNGARY	FL	0.400%	0.250%
ITALY	FL	0.100%	0.150%
ROMANIA	FL	0.400%	0.300%
SLOVAKIA	FL	0.450%	0.350%
SWITZERLAND	FL	0.150%	0.300%
UNITED KINGDOM	FL	0.100%	0.120%
CZECH REPUBLIC	HL	NEW SCENARIO	0.045%
SLOVENIA	HL	NEW SCENARIO	0.080%

As new scenarios were introduced for windstorm (**WS**) and hail (**HL**) but not earthquake (**EQ**) and flood (**FL**), the associated aggregation matrices on a region/country level for WS and HL were also updated.

NATURAL: CONTRACTUAL LIMITS:

EIOPA has assessed whether the sum insured used as input in the natural catastrophe risk calculations should be adjusted to account for specific policy conditions (e.g. contractual limits and deductibles) and proposes to introduce an 'ex-post adjustment' for each peril, which reduces the maximum loss for a zone if the

[4] The full Q&A may be found at: https://eiopa.europa.eu/regulation-supervision/q-a-on-regulation.

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maximum gross exposure using the undertaking-specific policy conditions is less than the gross loss using the existing standard formula approach.

Where an undertaking makes use of the proposed option and in particular in the case of further granularity, (e.g. group of homogenous contracts) discussion and disclosure should be included in the ORSA.

Capital requirements for interest rate risk

In the CP on its second set of advice, EIOPA states that strong evidence has been gathered to demonstrate that the existing approach for allowing for interest rate risk in the SF SCR leads to a severe under-estimation of the risks. The existing approach is described as not being effective in a low yield environment with negative interest rates. Its review of the interest rate risk module was an EIOPA own initiative.

In the CP, EIOPA provides two alternatives to the current methodology – a "minimum shock" approach and a "relative shift" approach and requested feedback from stakeholders.

FEEDBACK

The vast majority of stakeholders disagreed with the EIOPA conclusion that the alternative approaches proposed were appropriate candidates to adequately model interest rate risk in a low yield environment, and suggested to discard them.

In addition, several stakeholders proposed postponing potential changes to the interest rate risk module until the review of the treatment of LTGs during 2020. Stakeholders emphasised the material interconnectedness of changes in the interest rate risk module with the topics covered in that review project.

In addition, stakeholders criticised the current scope of the review into capital requirements for interest rate risk, questioning why they are not reviewing the entire market risk module, in particular, the market risk correlations.

CONCLUSION

EIOPA proposes the adoption of a relative shift approach, which it says is already widely used by Internal Model firms to model interest rate risk.

Intuitively the approach involves current risk-free rates being shifted upwards (by an additive amount A), a percentage stress B applied to the uplifted rates and the uplifted stressed rates then being shifted downwards by A to give the revised risk-free term structure.

The recommended approach involves the risk-free rates (R) first being multiplied by a factor (A), increasing or decreasing the curve as appropriate. The rates are then shifted by an additive factor (B), further increasing or decreasing the curve. The resulting term structure would have the form:

$$R * (1 \pm A) \pm B$$

The proposed factors A and B depend upon term and whether an upward or downward stress is being considered, but do not differ by currency.

EIOPA describes the impact of the new methodology as material. For a life undertaking which is exposed to the low-yield environment and uses the standard formula approach to calculate its SCR, the average impact on the solvency ratio is estimated by EIOPA to be a fall of around 14 percentage points (from a solvency ratio of 216% to a solvency ratio of 202%). EIOPA therefore proposes that the approach is phased in over the next 3 years and that only the downward shock is gradually implemented. It also proposes that the capital requirements for interest rate risk and their impact should be assessed as part of the review of Solvency II that the EC is required to undertake in 2021 (after 5 years of implementation).

Market risk concentration

Different assumptions are currently used by (re)insurers in the application of provisions, which stems from:

- Different understandings of single name exposures (**SNEs**) for counterparties owned by the same public entity; and
- The unavailability of a credit assessment by a nominated External Credit Assessment Institution (**ECAI**).

In the CP on the second set of advice to the EC, EIOPA laid out two alternative approaches for the calculation of the risk factor for market risk concentration; the "reverse mapping" option and the "average risk factor" option.

FEEDBACK

Stakeholders suggested a slight preference for the "reverse mapping" approach for calculating the risk factor.

In addition, stakeholders also welcomed the potential for further clarification and guidance on the definition of SNEs but did not feel that the Delegated Regulation was the appropriate place for this.

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CONCLUSION

Given that the two approaches give almost identical results and that stakeholders expressed a preference for the "reverse mapping" option, EIOPA has suggested this approach over the "average risk factor" option.

The "reverse mapping" approach involves mapping from solvency ratios to credit quality steps (**CQS**) consistent with Article 186. Table 1 below sets out the "mapping table" proposed by EIOPA.

(Re)insurance undertakings subject to the Solvency II regime and without credit rating	
Solvency Ratio	**CQS**
MCR not met	6
<=95%	5
100%	3.82
122%	3
175%	2
196%	1
Other exposures without credit rating	
(re)insurance undertakings referred to in Article 186 (4)	3.82
Credit or Financial institution referred to in Article 186 (5)	3.82
Exposures to insurers from third countries with equivalent solvency regimes that do not meet the local solvency requirements	5
Exposures to credit institutions and financial institutions referred to in Article 186(5) which do not comply with the solvency requirements in the banking regulation	5

For solvency ratios between those given in Table 1 above, the CQS should be linearly interpolated.

EIOPA also states that the same provisions should be applied for the counterparty default risk module (Article 199(4) to (7) of the Delegated Regulation).

Finally, EIOPA will consider whether it is necessary to provide further guidance on the definition of SNEs.

Currency risk at group level

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).

In the CP on the second set of advice, 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.

In the CP, EIOPA proposed the second of these two options as the best modification to the current methodology, but also sought the feedback from stakeholders on this.

FEEDBACK

Stakeholders welcomed the greater flexibility to select a reference currency other than the one used to prepare financial statements for the purpose of determining group currency risk capital requirements.

However, some stakeholders also suggested that EIOPA should:

- Extend the proposal to solo undertakings; and
- Allow insurers to use a basket of currencies, rather than one particular currency.

CONCLUSION

In the final report on the second set of advice, EIOPA has concluded that only the second option will form part of their advice to the EC; that groups are allowed to select a 'local' currency, different to their reporting currency. The group would then calculate the currency risk module with reference to this local currency. The logic underlying the proposal is that the group could theoretically change the reporting currency to the 'local' currency to reduce the group currency risk.

However EIOPA has specified that objective criteria should be used to determine the 'local' currency used. The currency in which the group has material technical provisions or material own funds are examples of such criteria.

EIOPA responded that considering the treatment of currency risk at the solo level was outside the scope of the call for advice and that the stakeholders did not present any evidence that currency risk is a material risk for solo undertakings. As such, the proposal will only be applicable to group insurers.

The proposal will only benefit insurance groups that have significant exposure to a single currency that is different to its reporting currency. EIOPA rejected suggestions to extend the proposal to a basket of currencies in order to widen the scope of companies that will benefit from the change, stating it had considered other options but concluded that those were not feasible in a standardised approach.

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Unrated debt

In the CP on the second set of advice to the EC, EIOPA considered how insurers should treat bonds and loans which have not been assigned a credit rating by a nominated ECAI.

EIOPA had proposed 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.

EIOPA advised that objective criteria (such as financial ratios) should be used as criteria to determine when these asset classes can be given the same treatment as rated debt.

Internal assessment approach

FEEDBACK

The scope of the proposals in the CP only allowed eligible unrated debt to be assigned to CQS 2 provided it can be demonstrated that the riskiness of the debt is in line with CQS 2.

Stakeholders strongly displayed preference for the expansion of the scope to include CQS 3, citing that there are larger volumes of CQS 3 borrowers and that it would be beneficial to be able to spread the costs for an internal assessment of the credit quality over a larger volume.

In addition, stakeholders were largely supportive of the internal assessment approach. However, regarding the “threshold” criteria for demonstrating eligibility (that were based on financial ratios) some stakeholders suggested that compliance with every ratio would be too strict, and others suggested that the ratios proposed were not appropriate for certain business sectors.

Finally, some stakeholders expressed concerns that the “yield criterion” for demonstrating eligibility would exclude a large amount of debt, with some stakeholders suggesting alternative approaches (e.g. using the spread instead of the yield).

CONCLUSION

In response to this feedback, in the final advice EIOPA has expanded the scope of the internal assessment approach to include CQS 3. That is, any eligible unrated debt can be assigned to CQS 2, or to CQS 3 if certain conditions, outlined in the final advice, are met which demonstrate that the riskiness of the debt is in line with the CQS.

Regarding the use of financial ratios in the assessment, EIOPA has stated that all financial requirements have to be met, and that a single set of financial ratios will be applicable for all business sectors. The only adjustment since the CP is that EIOPA has reduced the number of financial ratios that must be met, to four ratios.

EIOPA has decided to keep the yield criterion, with the only alteration since the CP being the introduction of a 0.5% add-on to allow for components in the yield on the debt of the borrower that are not related to credit risk.

In terms of other criteria that must be demonstrated, since the CP EIOPA has:

- Changed the requirement that there are semi-annual financial statements, to a requirement for annual statements;
- Revised the definition of seniority to allow for different structures that exist in practice; and
- Extended the scope to companies incorporated in the Organisation for Economic Co-operation and Development (in addition to the European Economic Area (**EEA)**).

All other criterion are unchanged since the CP.

Approved Internal Model approach

FEEDBACK

With respect to using the results of an approved internal model, most stakeholders were supportive, but expressed concerns that the proposed requirements were too onerous, did not reflect current market practice and would not be applicable in practice.

Furthermore, some stakeholders suggested that the approach should be expanded to relationships with companies that are not banks, such as asset managers and other financial intermediaries.

Finally, some stakeholders suggested that the scope was extended to allow also the use of internal ratings of an insurer that has received approval for a (partial) internal model.

CONCLUSION

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.

In the CP, EIOPA outlined criteria regarding the bank’s underwriting process, transparency and the avoidance of risk selection that must be satisfied before this approach may be used. In its final set of advice, EIOPA are to make no further changes to the proposed requirements as a result of the feedback from stakeholders, citing that they are required in order to ensure that the resulting credit quality steps adequately reflect the risk.

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Unlisted equity

In the CP on the second set of advice to the EC, EIOPA considers whether investments in the equity of companies that are not listed and are based in the European Union or EEA, either directly or otherwise, should be considered as type 1 equities provided that certain conditions are met.

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

FEEDBACK

A number of stakeholders emphasised that the suggested approach should be manageable and applicable in practice without significant effort.

In addition, some stakeholders supported the proposed 'similarity approach' (i.e. to check the similarity of the unlisted equities to listed ones in terms of fundamental risk drivers).

A few suggestions for potential changes to the similarity approach were made and, in addition, there were some critical comments regarding the assumptions and calculations underlying the two possible look-through criteria EIOPA had presented - the "Beta" method and the "stressed loss approach".

CONCLUSION

Regarding the similarity approach, EIOPA defended its proposed approach, reiterating that assessing the risk of unlisted equities was not a trivial task, that the approach is sensible, that the alternatives provided by stakeholders have meaningful disadvantages, and that the similarity approach was designed to have the advantage of being simple for insurers to implement.

There are no further changes since the CP as a result of stakeholder feedback, and so in the final set of advice EIOPA proposes that unlisted equities can be treated as type 1 equities if they satisfy certain objective criteria that show that the risk profile is similar to that of type 1 equities.

If the criteria cannot be met, the type 2 charge should be applied.

Strategic equity investments

In the CP on the second set of advice to the EC, EIOPA provided information to interested stakeholders relating to the approaches taken by insurers to evidence that equity investments are strategic in nature in order to benefit from a reduced equity stress (as described in Article 171 of the Solvency II Delegated Acts).

EIOPA did not propose any changes to the current approach but presented the results of a survey sent to NSAs that gathered information on the subject.

In its final advice, EIOPA sets out the feedback it has received on the current requirements when evaluating strategic participations and provides EIOPA's response to this feedback.

FEEDBACK

In their feedback to the CP, stakeholders highlighted two areas of concern in particular.

Firstly, stakeholders suggested that the requirement to evaluate strategic participations by demonstrating a lower volatility over the next 12 months was not appropriate because it contradicts the long term horizon associated with the nature of strategic participations. Stakeholders suggested that the volatility criteria should be removed and instead the criteria should focus on the actual risks to an insurer and in particular on the strong links between the insurer and the investee company, putting emphasis on the long-term holding capacity of the insurer and on its commitment to the activity of the investee company.

Secondly, stakeholders provided feedback that the minimum ownership and control threshold of 20% for an investment to qualify it as a strategic participation was too high and unnecessarily restrictive. Stakeholders proposed that this threshold be lowered to 10% or 5%. Stakeholders proposed applying the criteria for 'qualifying holding' as defined in Article 13 (21) of the Solvency II Directive, rather than the criteria for 'participation' (as defined in Article 13 (20)).

CONCLUSION

While EIOPA has noted the feedback from stakeholders, the scope of the advice from EIOPA to the EC is restricted to EIOPA providing factual information, hence EIOPA did not consider any changes at this stage.

Simplification of the counterparty default risk

In the CP on the second set of advice to the EC, EIOPA explored the complexity of the calculation of the counterparty default risk module and whether there is scope to develop simpler structures for this module. It presented a range of proposed simplifications and clarifications and invited stakeholder feedback.

FEEDBACK

In their feedback to the CP, stakeholders were broadly supportive of the set of proposals that have been presented by EIOPA for simplifying the calculation of the counterparty default risk module. The principal concern expressed by stakeholders

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was that the inclusion of excessive prudence in EIOPA's proposals (that was added to compensate for the uncertainty in the simplified approach) could discourage their widespread usage.

In addition, stakeholders agreed with EIOPA's proposal that a hedging strategy should be defined as a financial risk-mitigating technique. Some stakeholders highlighted to EIOPA that the full application of its proposal would need documentation requirements which are not too onerous.

Stakeholders requested further clarification regarding which derivatives should be treated as type 1 exposures, and also further details on how to calculate a risk mitigation effect for market risk and underwriting risk.

Finally, some stakeholders proposed that simplifications for the loss-given-default for reinsurance arrangements could be based on the solvency ratio or credit rating of the reinsurance counterparty. However, there were no concrete proposals submitted for EIOPA for consideration.

CONCLUSION

In response to this feedback, EIOPA has expressed that they do not believe that its proposals include excessive levels of prudence, reiterating that it had intended to include prudence in these optional, simplified calculations in order to reduce the risk of underestimating the counterparty default risk a company is exposed to.

Regarding the request that documentation requirements in relation to hedging strategies are pragmatic and realistic, EIOPA believes that this shall be part of the Pillar 2 issues – Investment risk management as described within Article 260(1c(iv)) of the Delegated Regulation. EIOPA will make clear that credit derivatives will not be covered in the counterparty default risk modules and therefore there shall be no double counting in the spread risk module.

Finally, EIOPA stated that they shall be providing no further clarification on how to calculate a risk mitigation effect for market risk and underwriting risk in relation to reinsurance contracts. Whilst EIOPA agree that the risk mitigation effect could cover both market and underwriting risks, they state that the method to use depends on the context that it is used, and as such, they do not feel further clarification on the matter is required. Instead, the calculation of the hypothetical SCR for market and underwriting risk should be calculated according to the appropriate articles of the Delegated Regulations.

There were no other alterations made to the initial proposals made by EIOPA in the CP, and further details on EIOPA's proposals can be found in the full report on the second set of advice.

Treatment of exposure to qualifying CCPs and changes resulting from EMIR

In the CP on the second set of advice to the EC, EIOPA proposed two approaches to derive the probability of default and the recovery rate for indirectly cleared derivative exposures:

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).

Option 2 - Where the derivative transaction meets the conditions set out in Article 305 (2) of the Capital Requirements Regulation[5] (**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%.

FEEDBACK

Some stakeholders requested adjustments to the requirements of Article 305 of CRR. The stakeholders stated that insurers usually do not obtain independent legal opinions on the consequences of a CCP default.

Of the options presented in the CP, most stakeholders supported "option 1" for the treatment of exposures to CCPs.

CONCLUSION

EIOPA sees difficulties in arguing for a less restrictive approach for insurers, given the risks in the case of a default by a CCP are not different to the risks for banks. In case there will be changes to the relevant CRR provisions then the Solvency II treatment would have to be reviewed for the need to reflect them.

Of the two options presented in the CP, EIOPA concludes that neither approach is clearly better, so EIOPA suggests one of them is used but does not recommend one option over the other.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

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Simplification of look-through

In the CP on the second set of advice to the EC, 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.

FEEDBACK

Most of the stakeholders supported EIOPA's proposals on simplifying the look-through approach, especially the amendment to Article 84(3) of the Delegated Regulation to allow the "grouping" of exposures when the target asset allocation is not available at the level of granularity necessary for all relevant sub-modules and scenarios of the standard formula, provided that "grouping" is applied in a prudent manner.

However, some criticised the proposals linking the simplified approach of Article 84(3) to Article 88, which is intended to ensure a consistent and prudent approach across all simplifications. They highlighted that there are already safeguards for prudence, namely that fact that the simplified approach can only be applied to up to 20% of the undertaking's total assets and the requirement for testing the asset allocation criterion.

In addition, some stakeholders highlighted that the requirement of Article 84(3) to "strictly" manage the collective investment fund according to the target asset allocation, or the latest reported asset allocation, could lead to misinterpretation. To address this, stakeholders proposed to replace the requirement "strict" with "consistent" in Article 84 (3) and Article 84(3)(b) of the Delegated Regulation.

CONCLUSION

Having considered stakeholders' feedback, EIOPA stated that it believes the proposal in the final advice needs to be complemented by a qualitative condition linked to Article 88. This would ensure that undertakings might apply a simplified look-through more widely, provided the error introduced in the simplified calculation is not material. This is in line with the proportionality framework of the standard formula and avoids wrong incentives for not applying the look-through approach when the equity risk type 2 stress factor is likely to be above 49% in the calculation of the equity risk sub-module.

Regarding criticism from stakeholders around the use of "strictly" in Article 84(3), EIOPA has stated that it is more in favour of proposing a deletion of the word from the Article altogether, as it feels that the suggested alternative to use "consistently" would in fact make the meaning vaguer. In order to calculate the SCR based on the target asset allocation, assets should evidently be managed, and all underlying risks valued, according to that allocation.

Finally, EIOPA clarify in its advice that the last reported allocation might be used when exposures and risk are not supposed to vary materially over a short period of time.

Further details on the conclusions proposed by EIOPA in the original CP, that are unchanged in the final report on the second set of advice, can be found in this paper.

Look-through approach at group level

In the CP on the second set of advice to the EC, EIOPA analyses how the look-through approach is applied at group level for related collective investment undertakings. In the CP, EIOPA proposed two options to stakeholders and requested feedback on them. These options were:

Option 1 - Maintain the current Delegated Regulations and provide more guidance to supervisors as to when they should consider investments as related.

Option 2 - Recommend a change to the Delegated Regulations so that related undertakings are treated the same at group level as they are at solo level.

FEEDBACK

Most of the stakeholders supported the option 2 and justified their preference by explaining that the calculations would be simpler and more risk-sensitive.

CONCLUSION

EIOPA agrees with the stakeholders' comments and the advice to the EC has been modified accordingly in its final report to only include option 2.

In addition, in the final report to the EC, EIOPA expands on its advice and comments that applying look-through means that the SCR for these related undertakings will be calculated taking account of diversification benefits within each related undertaking. They go further to question whether diversification benefits between underlying assets in related undertakings and other assets appearing on the consolidated balance sheet should be recognised in the group SCR calculation.

EIOPA comments that in the case where these related undertakings are controlled, diversification benefits with other consolidated assets can be justified since the group integrates fully the underlying assets within its investment strategy. Where these related undertakings are not controlled, the group has no control on the underlying assets and as such not recognising diversification benefits with other consolidated assets would be more appropriate.

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Loss absorbing capacity of deferred tax

In the CP EIOPA outlined the differences in approaches for the calculation of the LACDT and concerns with the current calculation practices, EIOPA highlighted several key principles to bring about supervisory convergence, and also suggested a simplification to the calculation of LACDT in order to reduce the complexity surrounding the calculation.

FEEDBACK

Stakeholders shared their opinion both on the general approach that was proposed by EIOPA in the CP, and also provided comments specific to the key principles. The general comments made were:

- There is, as yet, insufficient evidence of any issues with LACDT, and that the EC had not specifically asked EIOPA to advise on LACDT;
- Stakeholders did not want EIOPA to propose any hard limitations on the calculation of LACDT (arguing that this may restrict the recognition of potential LACDT);
- There were mixed opinions on the interpretation of the going concern principle and the use of future management actions in calculating the LACDT;
- Assumptions should be based on best-estimate (not prudent) assumptions; and
- Several of EIOPA's proposals were not in line with the valuation and recognition principles of IAS12[6].

Additional feedback on the 'key principles' can be found in the full report.

CONCLUSION

On review, and after stakeholders' comments, EIOPA has advised to not introduce a simplified calculation for LACDT.

After receiving comments from stakeholders, EIOPA has advised amendments to Article 15, 23, 83, 207, 260, 272, 297 and 311 to help bring about convergence on the treatment of LACDT demonstrated by future profits. The following changes to the Delegated Regulation are proposed:

- When utilising an increase in the DTA, undertakings must take into account:
  - Time limits relating to carry-backs and carry-forwards;.
  - The impact on the undertaking post-shock; and
  - The increased uncertainty post-shock.
- Undertakings shall not apply assumptions that are more favourable than those used pre-shock for the calculation of LACDT.
- It is appropriate to set post-shock assumptions on returns on assets equal to the forward rates derived from the relevant interest rate term structure. However, it should be recognised that in certain circumstances, higher returns are justifiable, potentially including the matching or volatility adjustment.
- Undertakings shall not assume new business sales in excess of those projected for the purpose of their business plan and shall not project new business sales beyond the horizon of their business plan (and not beyond of maximum of five years).
- An assessment of the results of the future management actions against experience should be included in the future management actions plan.
- The Actuarial Function shall assess and validate the underlying assumptions applied for the projection of future profits. This may be delegated to risk management function.
- In the SFCR and RSR, undertakings are required to clearly explain the amount of deferred tax asset and the extent to which it has been recognised. They are also required to show how they calculate their deferred tax assets and LACDT, and to demonstrate that it is likely that they can be utilised in the future.

Risk margin calculation

In the CP on the second set of advice to the EC, EIOPA limited its review of the risk margin to the appropriateness of the CoC rate used in the risk margin calculation, in the light of changes to the market environment. EIOPA proposed not to change the current CoC rate of 6%.

FEEDBACK

EIOPA reported that stakeholders expressed discontent regarding the level and current formula of the risk margin.

In addition, stakeholders expressed general disappointment that no other areas than the cost of capital were considered, feeling that a wider range of approaches to the risk margin should be considered (e.g. concepts equivalent to the risk margin in IFRS17).

[6] IAS12 prescribes treatment of income taxes.

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CONCLUSION

EIOPA has advised that the review of aspects of the risk margin other than CoC should be done as part of the review of Solvency II that the EC is required to undertake after five years of implementation (in 2021).

EIOPA does not recommend a change to the 6% rate for CoC and its rationale for maintaining it at its current level includes:

- recalculating the CoC by applying the same methodology originally used to calibrate it (a backwards-looking capital asset pricing model) to data that includes more recent market experience gives a CoC range of 6.7% to 7.8%, which is similar to the current 6% level;
- a forward-looking dividend discount model approach requires too many significant assumptions on future economic development;
- expert opinion is that there is no statistically significant relationship between interest rates and the equity-risk premium required by investors in insurance entities, and therefore low interest rates are not an argument to decrease the CoC rate; and
- the CoC is intended as an over-the-economic-cycle parameter and so, again, low interest rates are not an argument to decrease the CoC rate.

Comparison of own funds in insurance and banking sectors

The EC requested that EIOPA evaluates differences between the classification and treatment of comparable own fund items under the banking sector's CRR and the Delegated Regulation. In the CP, the three main points of difference identified in EIOPA's 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.

FEEDBACK

In their feedback to the proposals in the CP on the second set of advice to the EC, some respondents argued that PLAM should only trigger at the point of gone concern and that rT1 triggers should be amended in a similar manner. EIOPA disagreed with this in its response and explained that Tier 1 capital is expected to be available to fully absorb losses on a going concern basis.

Responses to most of the other proposals in this area were broadly supportive of EIOPA's proposals and in some cases resulted in some wording changes to clarify the proposed approach. A small number of respondents disagreed with specific elements of EIOPA's proposed advice but EIOPA disagreed with these assertions and its proposals are consistent with the proposals outlined in the CP.

CONCLUSION

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

- To permit partial write-down of rT1 instruments on a straight-line basis, provided that neither the Minimum Capital Requirement (**MCR**) nor 75% SCR coverage are breached;
- That further write-down is required only in the event of a worsening in the SCR coverage following an initial breach, with the SCR coverage being recalculated every three months until compliance with the SCR is restored;
- That this approach should be applied (subject to necessary alterations) to rT1 instruments which convert on trigger;
- To continue to allow for full recognition of the principal amount of rT1 instruments on issuance (therefore not making any changes to align with CRR);
- To permit requests for waivers from compulsory write-down if such a write-down would lead to a tax liability arising; and
- To consider changes to bring Solvency II closer to alignment with CRR (November 2016 draft) regarding tax and regulatory calls: EIOPA recommends permitting 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 as rT1 or "hybrid" instruments.

In the CP on the second set of advice to the EC, EIOPA considered two options and invited feedback from stakeholders on them:

- To retain the limit in its current form; or

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- To remove it and strengthen the quality of rT1 instruments.

FEEDBACK

Most stakeholders expressed a 'strong preference' for the retention of the 20% limit and suggested that strengthening the quality of hybrid T1 instruments would not protect the quality of Tier 1 own funds should the limit be removed. This is consistent with the EIOPA's draft advice in CP-17-006 where it presented.

Some respondents also commented that removing the 20% limit would provide a large ex-post subsidy to undertakings which have a lot of legacy instruments which had transitioned into rT1.

On the option to strengthen the quality of rT1 instruments, feedback from stakeholders supported EIOPA's view that there are no changes to the features of hybrid instruments that would fully mitigate the resulting loss in capital quality. In this assessment, stakeholders argued that extending the call date of rT1 instruments, or disallowing call dates completely, would not improve their permanence. Whilst stakeholders did not support the suggestion to improve the loss absorbency of rT1 instruments which write down by requiring full write down immediately in the event of any of the mandatory triggers occurring, EIOPA did not receive much feedback as to why stakeholders did not support this proposal.

Other alternative ways to strengthen the quality of rT1 instruments proposed were to change the mandatory triggers which stakeholders stated would reduce market access for issuers.

CONCLUSION

EIOPA has advised the EC to retain the 20% limit in order to protect the prudential quality of tier 1 own funds. EIOPA states that it cannot support any regime in which hybrid instruments could represent all or the most significant part of Tier 1. If the 20% were removed, EIOPA believes that there are no changes to the features of hybrid instruments that would fully mitigate the resulting loss in capital quality.

EIOPA analysed the 2016 annual reports of a range of companies and concluded that very few undertakings were affected by the 20% limit, and therefore that the limit did not appear to be a material impediment to the industry.

This is consistent with EIOPA's preferred proposal outlined in CP-16-006.

Article 209(3): Allowed adjustments

In its first set of advice to the EC EIOPA suggested that weekly adjustments (formerly every three months) to risk-mitigation techniques (**RMT**) should be allowed, provided they are "exposure adjustments and it was stated that EIOPA would provide further clarifications in the second advice".

Article 209 (3) of the Delegated Regulation allows, under certain conditions, the full recognition of RMT where contracts with maturity of less than 12 months are used and where the replacements that are used are 'similar'.

In the second set of advice, EIOPA flags a number of potential issues:

- The term 'similar' can be ambiguous and has been interpreted in many ways. EIOPA has clarified that similarity should not simply mean the use of the same type of instrument;
- Although some RMT create an 'option-like return' they should not be considered as 'similar' arrangements;
- Based on the requirements for the SCR in Article 101(3) of the Delegated Regulation, adjustments should only be 'allowed' provided the risk-mitigating effect taking into account exposure adjustments is not overestimated when compared to the risk-mitigating effect reflected in the standard formula SCR calculation taking into account hedging instruments that are currently in place. This condition is one interpretation of the 'similarity' requirement as stated in Article 209(3) of the Delegated Regulation. In the CP, EIOPA have flagged that the difficulty of demonstrating compliance with this criteria will depend on the complexity of the hedging strategy;
- Any adjustment should not introduce material basis risk; and
- If the terms of the adjustment frequency is adjusted to be weekly, it becomes even more important that adjustments result in prudentially sound outcomes.

In the second set of advice, EIOPA presents five examples showing a comparison between the calculations based on the standard formula SCR calculation, with those allowing for exposure adjustments. This aims to highlight situations where the risk-mitigating effect taking into account exposure adjustments is overstated when compared to the SCR calculation.

USP for lapse risk

EIOPA has answered the call for advice from the EC on USP in its first set of advice (BoS-17/280). In its advice, EIOPA has stated that it "will further consider the methodologies proposed by stakeholders for USP on lapse risk and provide its final advice by February 2018".

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In the CP on the second set of advice to the EC, EIOPA sets out the stakeholders' proposal and EIOPA's advice to the EC on this proposal.

STAKEHOLDERS' PROPOSAL

Stakeholders proposed a methodology for Life lines of business to estimate the stress factors for a permanent increase and decrease in lapse rates, but not for the mass lapse stress.

The data requirements for this approach would consist of data for the number of lapses experienced and the number of total policies in force available for at least 10 reporting periods and adjusted for:

- Any mass lapse event to the extent that the risk of those events are reflected in the mass lapse risk submodule; and
- Any significant trend in lapse rates.

Annual lapse ratios would be derived by comparing the crude lapse rates for a year with that from the previous year. The lapse ratios would be assumed to follow a lognormal distribution and the ratios derived would be used to estimate the parameters for the distribution. Finally the 0.5% and 99.5% quantiles would be used to derive the lapse up and lapse down stress.

EIOPA's assessment of proposal

EIOPA states that to be consistent with the lapse risk module calibration it would appear more sensible to only apply a USP on the entire portfolio and not to apply USP on a specific life line of business level. The proposals also do not include a potential adjustment for reinsurance contracts and EIOPA suggests a data requirement about reinsurance should be added. EIOPA also flags that no detailed suggestions or criteria was provided on how the adjustment for mass lapse would be carried out.

EIOPA's advice

EIOPA notes that the proposed methodology for USP for lapse risk is similar to the one used to calibrate the standard formula.

EIOPA does not advise the EC to reflect the methodology proposed in the Delegated Regulation. If, overall, the proposal replicates the calibration of the standard formula, it is not considered to reflect the risk profile of the undertaking better than the standard formula.

The expert judgment embedded in the proposed methodology would imply detailed documentation and reviews which also do not appear proportionate to a USP methodology.

Recognition of adverse development covers

In CP-16-008 published in December 2016, one of the responses to the discussion paper to review, stakeholders proposed to recognise Adverse Development Cover (**ADC**) treaties in the standard formula calculation for premium and reserves risk. The standard formula is criticised by certain stakeholders for not sufficiently recognizing non-proportional reinsurance covering non-life risks.

EIOPA engaged with stakeholders on this topic and this advice sets out a technical analysis of the proposed solutions it has received from stakeholders and provides EIOPA's final advice on whether or not these covers should be recognised in the standard formula.

FEEDBACK

Stakeholders propose to recognise ADC in the standard formula for premium and reserve risk and to amend Article 117 of the Delegated Regulation with a specific formula to account for the risk mitigating effect of ADC.

The stakeholders' first proposal to incorporate ADC into the standard formula was challenged by EIOPA who raised concerns that the proposed formula would double count the contribution of ADC and therefore would result in an SCR that underestimates the actual risks.

The stakeholders responded with further formula modifications to address this feedback, including proposals to specify the characteristic limits of ADC (concerning attachment point and exit level) to ensure the risk is not underestimated. However, EIOPA's analyses of the proposed refinements demonstrated that there are still cases of underestimation, and that underestimation would likely increase with time (in a situation where the best estimate for reserves covered decreases over time).

Stakeholders agreed with EIOPA's analyses and responded with a third proposal, taking contract pay-outs into account to stabilise the overall effect of the reinsurance cover. EIOPA demonstrated that even with complexity amendments, the methodology was not sufficiently prudent.

CONCLUSION

Despite several amendments, EIOPA's technical analysis demonstrated that the proposed formula modifications would result in underestimation of real risk.

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Only in the case of mono-line insurers would the proposed formula changes produce sufficiently prudent results, but EIOPA believes it would be inappropriate to recognise ADC in only that specific case.

EIOPA does not advise recognising ADC on the basis of the stakeholders' proposal.

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