

The 2020 Solvency II Review and update on earlier amendments

European Commission issues Call for Advice

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Highlights

The Solvency II Directive requires that certain areas must be reviewed by the European Commission by the end of 2020. The Commission has now written to EIOPA requesting its advice by 30 June 2020 on items that it has identified as deserving a reassessment.

Key items which will be under scrutiny by EIOPA are as follows:

- The **last liquid point** underlying the risk-free term structure of interest rates for various currencies. Based on previous EIOPA communications there may be a move to increase the last liquid point for the Euro from 20 to 30 years which could significantly increase the value of certain types of long-term liabilities.
- The **cost of capital rate** for the risk margin (currently set at 6% per annum) as well as a consideration of allowing varying cost of capital rates for different types of business.
- A reassessment of **supervisory convergence**, including divergent practices around the best estimate calculations, the life and SLT health underwriting risk modules and the supervisory response to MCR breaches.
- A review of the long-term guarantee measures including the functioning of the **volatility adjustment** and **matching adjustment**.

As part of the interim review of the Solvency II Delegated Regulation in 2018, the Commission has already carried out a wide-ranging review of the methods, assumptions and standard parameters used when calculating the SCR under the standard formula. However, changes to the **interest rate risk** sub-module of the SCR were specifically deferred by the Commission until the 2020 review. In view of previous advice from EIOPA it might be expected that this will be an area attracting considerable attention, with the possibility of material increases in capital requirements as a result of changes to the calibration of the stress scenarios.

EIOPA will also have to advise on the **equity risk and spread risk** sub-modules of the SCR. The Commission's request hints at the possibility of a dampening of the current stress scenarios so as to take into account the long-term nature of (re)insurance business.

The Commission also opens the possibility of changes to the **underwriting risk** module of the SCR but requires industry stakeholders to provide data to support any such amendments.

(Re)insurers will welcome the Commission's reiteration of the need for **proportionate application of the rules** and in this regard EIOPA is asked to review the following specific areas:

- Supervisory reporting and public disclosure
- Simplification of the counterparty default risk module
- The application of simplified methods for sub-modules of the SCR which are deemed immaterial
- Waiver of certain requirements where appropriate based on size thresholds or the nature of business

It is also noteworthy that the following areas of the Solvency II rules are not explicitly covered in the current Call for Advice:

- Operational risk module of the SCR
- Concentration risk sub-module of the SCR*
- Property risk sub-module of the SCR
- Sovereign credit exposures
- Loss absorbing capacity of deferred taxes*
- Loss absorbing capacity of technical provisions
- Undertaking-specific parameters (USPs)*
- Capital add-ons*
- Internal models (except for dynamic volatility adjustments)

**Note: These items were somewhat covered in the 2018 Interim Review*

In forming its advice, we expect that EIOPA will issue a series of industry consultations addressed to various stakeholders over the coming months. Any proposed changes will be high on the agenda of **Actuarial functions** and **Risk functions** and (re)insurers will need to carry out an impact assessment in relation to areas affecting them.

In the remainder of this briefing note we set out in more detail the areas covered by the Commission's latest request for the 2020 review of the whole Solvency II framework.

We also cover a separate request that the Commission has issued to EIOPA related to insurers' asset and liability management which is also part of the 2020 review process. In the final section we provide an update on the latest news in relation to the 2018 interim review of the Solvency II Delegated Regulation.

Call for Advice on the 2020 Review

On 11 February 2019 the European Commission (**EC**) issued a formal Call for Advice¹ to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (the “**2020 Full Review**”) in accordance with the Solvency II Directive (as amended by the Omnibus II Directive). That review is explicitly required to cover the following areas:

- The long term guarantee (**LTG**) measures and measures on equity risk i.e. the extrapolation of the risk-free rate; the matching adjustment (**MA**); the volatility adjustment (**VA**); the extension of the recovery period in case of non-compliance with the Solvency Capital Requirement (**SCR**); the transitional measures for technical provisions and the risk-free rate; the symmetric adjustment mechanism for equities; and the duration-based equity risk sub-module
- The methods, assumptions and standard parameters used when calculating the standard formula SCR
- Member States’ rules and supervisory authorities’ practices regarding the calculation of the Minimum Capital Requirement (**MCR**)
- Group supervision and capital management within a group of insurance or reinsurance undertakings

It is noteworthy that the Call for Advice begins by stressing that *“the fundamental principles of the Solvency II Directive should not be questioned in the review (including the confidence level underlying the calibration of capital requirements and the market-consistent valuation)”*.

Notwithstanding the specific areas set out above, the EC also signals that a *“holistic and thorough assessment of the framework”* should be carried out, and in that regard the EC has set out a long list of areas for EIOPA to consider in its advice. The scope of review covers the Solvency II Directive itself, as well as the Delegated and Implementing Regulations.

EIOPA is required to deliver its advice by 30 June 2020. We would expect that, in the period up to the delivery of that advice, EIOPA will be issuing a number of consultations to industry and other stakeholders. The actual implementation date for changes to the Solvency II rules following the 2020 Full Review remains unclear.

The EC also notes it may issue further Calls for Advice as part of the 2020 Full Review.

A high-level overview of the particular aspects that EIOPA has been asked to analyse is set out in the Appendix of this note.

¹https://eiopa.europa.eu/Publications/Requests%20for%20advice/RH_SRAnnex%20-%20CfA%202020%20SII%20review.pdf

²https://eiopa.europa.eu/Publications/Requests%20for%20advice/signed_letter_08_02_19.pdf

MA and VA – Possible Changes?

The EC also sent a letter² to EIOPA on 7 February 2019 requesting investigations regarding possible interim changes to the methodology for the activation of the “country component” of the VA in advance of the 2020 Full Review. No specific timeline for these investigations has been set out.

Currently the VA applies on a standardised basis for liabilities relating to a particular country and denominated in a particular currency. There has been some criticism of the “country component” by various industry stakeholders with arguments that it does not react appropriately to country-specific spread crises.

Interim changes to the methodology would be confined within the existing Solvency II Directive rules without legislative changes. However, in its Call for Advice on the 2020 Full Review, the EC also asks EIOPA to carry out a more widespread review of the functioning of the VA as well as the MA with the possibility of proposing legislative changes.

In the Call for Advice for the 2020 Full Review, EIOPA has also been asked to assess the quantitative impact on the calculation of the best estimate and the solvency position of undertakings of the following two alternative approaches for the calculation/application of the VA (both reflecting a form of “own company VA”):

- Approach 1: use of an “application ratio” to the VA rate based on the specific illiquidity features and/or duration of an undertaking’s own liabilities
- Approach 2: use of an “application ratio” to the VA rate based on the specific asset holdings of an undertaking, possibly also reflecting the degree of cashflow matching of insurance liabilities

EIOPA has also been asked to assess the quantitative impact on the calculation of the best estimate and the solvency position of undertakings of the following two alternative approaches for the calculation/application of the MA:

- Approach 1: a reconsideration of the current approach of assuming no diversification between different matching portfolios as well as with other non-matching portfolios
- Approach 2: a review of the criteria for eligible assets in a matching portfolio

EC Request for Information on ALM

On 27 April 2018 the EC issued a Request for Information³ to EIOPA related to insurers’ asset and liability management (**ALM**) which was also in the context of the 2020 Full Review. EIOPA’s

³<https://eiopa.europa.eu/Publications/Requests%20for%20advice/Requests%20for%20information%202018-04-25.pdf>

actions on the back of this request remain ongoing and in this section we provide a status update.

The Request for Information related to the specific objectives set out in the 2020 Full Review concerning the availability of long-term guarantees in insurance products, the behaviour of insurers as long-term investors and, more generally, financial stability.

The EC's Request for Information covered the following items:

- Information on insurance liabilities – this covered information on the actual and potential liquidity of these liabilities.
- Information on insurers' asset management – this covered information on the period over which the different types of investments are effectively held by insurance undertakings.
- Information on the LTG measures including the MA and VA.
- Information on the market valuation of insurance liabilities – this covered information on the actual transfer of insurance liabilities between insurance and reinsurance undertakings.

EIOPA is required to submit the information it gathers to the EC by 16 December 2019. The EC also said that it will take into account EIOPA's annual LTG reports, the latest of which was issued in December 2018.

Subsequent to the EC's Request for Information, EIOPA issued a Request for Feedback⁴ covering the first two items in the EC's request i.e. insurance liabilities and insurers' asset management. The period for submissions closed on 7 December 2018 and following this EIOPA has indicated it will launch a consultation in early 2019 covering the full list of items in the EC's Request for Information. EIOPA also says it will further consult in the autumn of 2019 before making its submissions to the EC.

At Milliman we have published a White Paper⁵ discussing EIOPA's Request for Feedback.

Interim Review of Delegated Regulation

The Solvency II Delegated Regulation stipulated that a provisional review of the methods, assumptions and standard parameters used when calculating the SCR with the standard formula should be carried out by the EC by the end of 2018 under advice from EIOPA (the **"2018 Interim Review"**).

Further to this, in late 2017 and early 2018 EIOPA carried out public consultations in view of forming its advice to the EC. At Milliman we published a series of briefing notes⁶ on EIOPA's consultations and final advice submitted to the EC. The focus of EIOPA's advice was on trying to reduce complexity.

In November 2018 the EC published its final proposals⁷ on interim changes to the Delegated Regulation. In its proposals the EC

reflected most of the EIOPA advice. The main amendments made by the EC compared to the EIOPA advice included the following:

- Rejection of EIOPA's proposed changes to the calibration of the interest rate risk sub-module of the SCR. In its Final Advice EIOPA had submitted its "own initiative" advice on the treatment of interest rate risk beyond the scope of the EC's original request. However, this risk module is part of the 2020 Full Review and it is widely expected that the current standard formula treatment will be changed in view of criticism that it does not function appropriately in a low interest rate environment. It is worth noting that internal model firms typically apply significantly more severe stresses than under the standard formula rules.
- No limit applied on the application of alternative SCR methods to unrated debt and unlisted equity. EIOPA had proposed a 5% limit relative to aggregate investments.
- The introduction of a reduced capital charge for a new class of "long-term equity investments".

At the time of writing this briefing note the EC's final proposals are still undergoing review within the EU legislative structures and it remains unclear when any changes will take effect.

How Milliman can help?

We will be working with our clients to help them assess the potential impact of any changes on their business and examine possible capital management solutions and strategic initiatives which could be used to optimise the capital position.

Areas where we can offer support to companies include:

- Estimating the impact of changes on technical provisions, SCR and own funds
- Investigating the consequences for business planning and ORSAs
- Formulating risk-mitigating measures including the use of techniques such as hedging and asset rebalancing
- Assessing the implications for asset-liability management including interest rate risk management
- Re-evaluating the merits of the use of the volatility adjustment and matching adjustment
- Consideration of impacts on the system of governance and the risk management system
- Advising on strategic issues such as the relative impact of any changes on different types of business and the consequences for business mix management

⁴https://eiopa.europa.eu/Publications/Consultations/EIOPA-PSC-18_093_Request_for_Feedback_Illiquid%20Liabilities.pdf

⁵<http://www.milliman.com/insight/2019/Illiquid-liabilities-A-myth-or-a-reality/>

⁶<http://ie.milliman.com/uploadedFiles/insight/2018/EIOPA-Second-Set-Advice.pdf>

⁷https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-5720906_en

Appendix

Contents of EC Call for Advice on the 2020 Review

Extrapolation of the risk-free interest rate term structure

- Review of the last liquid point

Matching adjustment and volatility adjustment

- More details provided earlier in this briefing note

Transitional measures

- Review of transitional measures on technical provisions and the risk-free rate, and the duration-based equity risk sub-module, in terms of policyholder protection and a level playing field for industry participants

Risk margin

- Review of the risk margin design (whilst maintaining the current cost of capital methodology)
- Review of the assumptions regarding the asset mix of the reference undertaking
- Review of the use of a fixed cost-of-capital rate for all undertakings
- Review of the assumptions used to derive the cost of capital rate

Long-term investment (“Capital Markets Union” aspects)

- Review of the market risk module of the SCR for long-term investments (in particular equity risk and spread risk)
- Review of the equity risk sub-module of the SCR as regards the duration based equity risk sub-module, strategic equity investments and the symmetric adjustment mechanism for equities
- Review of correlations under the standard formula, in particular for market risk as well as the correlation of lapse risk with market risks

Review of dynamic volatility adjustments for internal model firms

- An assessment of the appropriateness of current practices with regard to so-called dynamic volatility adjustments in internal models (DVAs)
- Consideration of criteria to improve the level of harmonisation of modelling approaches

Standard Formula SCR

- Review of the interest rate risk sub-module of the SCR
- Assessment of potential further simplification of the counterparty default sub-module of the SCR and a

review of whether certain asset types should fall under the equity risk sub-module or the counterparty default risk module

- Review of the consistency of application of the life underwriting risk and SLT health underwriting risk sub-modules of the SCR and the potential for further simplifications
- Review of the consistency of application of the non-life lapse risk sub-module of the SCR and the potential for further simplifications
- Review of the calibration of the underwriting risk sub-module of the SCR (for all of life, non-life and health)
- Specification of the national market average conditions for cover underlying the calibration of the natural catastrophe risk sub-module

Consistent treatment of financial risk mitigation across Standard Formula and Internal Models

- Clarification of the definition of a financial risk mitigation technique and of other financial instruments that may be used to reduce the SCR, with a view to ensuring consistent treatment between the standard formula and internal models. EIOPA is also asked to indicate the criteria and methods to determine the amount of risk reduction or transfer that may be recognised for such items.
- Consider if provisions on assessment of basis risk are clear and, if necessary, advise on improvements

MCR

- Report on the application of the cap and the floor
- Report on issues faced by supervisors with regard to the calculation
- Report on consistency of the calibration with a 85% confidence level
- Report on potential divergences in supervisory practices in cases of non-compliance with the MCR
- Report on potential issues with regard to the identification of eligible basic own funds items for composite undertakings

Macro-prudential issues

Review the following items in the context of whether the Solvency II Framework allows for appropriate macro-prudential supervision⁸:

- The Own Risk and Solvency Assessment (ORSA)
- Systemic risk management plans
- Liquidity risk management planning and liquidity reporting
- The prudent person principle

⁸ The European Systemic Risk Board (ESRB) also recently published a report ([link](#)) on macro-prudential provisions, measures and instruments for (re)insurance

Development of the Recovery and Resolution rules

- Review of early intervention powers, preventative recovery planning, and anything else EIOPA feels is appropriate

Harmonisation of insurance guarantee schemes

- Assessment of the need for minimum harmonising rules for national insurance guarantee schemes that protect policyholders in the event of an insurer's failure (including business sold on a cross-border basis)

Freedom to provide services & freedom of establishment

- Assess whether home National Supervisory Authorities and EIOPA have sufficient powers to prevent failures of cross-border insurers and to properly assess the fit-and-proper requirements

Group supervision issues

Advise on fixing issues highlighted in EIOPA's December 2018 report⁹, in particular EIOPA is asked to focus on:

- The scope of group supervision
- Calculation of group solvency
- Appropriateness of minimum consolidated group SCR
- Uncertainties or gaps related to group governance requirements

Reporting and disclosure¹⁰

- Review of the ongoing appropriateness of the requirements
- Whether the required content, frequency and deadlines for SFCRs and RSRs (including QRTs) are appropriate and proportionate

Enhancement of proportionality rules

- Appropriateness of thresholds for exclusion from the scope of Solvency II for certain firms
- The possibility to waive certain requirements subject to particular criteria
- Rules for the simplified calculation of sub-modules that form an immaterial part of the SCR for a firm

Best estimate

Covers concerns over and, if necessary, advice for remediation of divergent supervisory practices with regard to the calculation of the best estimate in the following areas:

- the use of Economic Scenario Generators
- the application of contract boundaries
- the application of future management actions
- the treatment of expenses and investment costs
- the valuation of options & guarantees

Own funds tiering

- Consideration of differences in the tiering of own funds between insurers and banks
- The extent to which the tiering rules may generate undue volatility of own funds
- Whether the availability criteria for own funds are sufficiently clear and appropriate
- A review of the tiering allocation as regards the characteristics of permanent availability and subordination of particular own funds items

Reducing reliance on credit ratings

- The 2018 Interim Review has already considered the treatment of unrated debt using alternative methods. As part of the 2020 Full Review, EIOPA is asked to advise on the wider use of those alternative credit assessments. For example, this could mean applying such assessments where the corporate exposures have a credit rating.

Treatment of reinsurance for non-life business

- Review of the recognition of the most common non-proportional reinsurance covers for non-life underwriting risks in the SCR standard formula, as well as for adverse development covers and finite reinsurance covers.

⁹<https://eiopa.europa.eu/Pages/News/EIOPA-reports-on-Group-Supervision-and-Capital-Management-of-Insurance-and-Reinsurance-Undertakings.aspx>

¹⁰ EIOPA also recently published a consultation paper ([link](#)) on the review of reporting and disclosure



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