Insurance Europe general comments on the EIOPA discussion paper on the review of specific items in the Solvency II Delegated regulation

Insurance Europe welcomes the opportunity to provide feedback on EIOPA's discussion paper on the review of the Solvency II Delegated Regulation. The industry notes that several elements in the Solvency II package deserve a careful reconsideration and addressing by policymakers. Many of these elements were already identified and raised by the industry ahead of finalisation of the Solvency II package, but it was not possible to address them at that time. In addition, the implementation and application of the Solvency II framework over the past two years has revealed a range of new areas where there is scope for improvement.

Insurance Europe appreciates that the scope of the review, as identified by the Commission in its call for advice, is used by EIOPA as a basis for a comprehensive discussion paper, which offers the industry the right opportunity to provide input on emerging concerns and identify area where improvements are needed. However, Insurance Europe believes that one particular area raised in the discussion paper, namely the interest rate risk sub-module, which does not form part of the EC call for advice, should not be looked at as part of the 2018 review but rather as part of the 2020 review, as this is closely linked not only to the overall political agreement of the Solvency II framework of 2013, but also because technically the issue is closely linked to the long-term guarantees package, which is itself under the scope of the 2020 review.

The key positions of Insurance Europe on the areas under discussion are as follows:

1. Simplified calculations

Proportionality is an overarching principle of Solvency II as described in the Framework Directive. Insurance Europe welcomes that simplified approaches and calculations are investigated in this discussion paper, which should allow for a wider and consistent application of simplifications in several key areas, identified in the more detailed responses to the relevant questions.

2. Reducing reliance on external credit ratings in the standard formula

While Insurance Europe understands policymakers' objectives to reduce reliance on ECAI ratings, it highlights that, in practice, it would not be feasible nor desirable to refrain from any references to external ratings. Insurance Europe therefore believes that the ability to use ratings provided by ECAIs should be preserved in the framework. No changes should be made to increase costs for companies using ECAIs. Insurance Europe supports efforts to reduce reliance by allowing the use of alternatives to ECAIs, including internal credit risk assessment models, as well as other private or public credit risk assessment models, subject to appropriate supervisory controls.

3. Treatment of guarantees, exposures guaranteed by a third party and exposures to regional governments and local authorities (RGLA)

Insurance Europe strongly supports a better recognition of the risk-mitigating effect of guarantees in Solvency II, aimed at reflecting both the risk-based nature of the framework and the economic reality of insurers' risk exposures.

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Specifically, exposures containing guarantees by an RGLA and guarantees by entities equivalent to an RGLA or a central government should receive the same treatment as direct exposures to a central government or an RGLA. Additionally, the risk-mitigating effect of partial guarantees should be recognised in a similar way to full guarantees, and proportionally to the actual (partial) risk coverage.

4. Risk-mitigation techniques (RMT)

Insurance Europe highlights the need for a more appropriate recognition of risk-mitigation techniques in Solvency II, recognizing their actual contribution to the risk management of insurers. Insurance Europe notes the following:

- **Qualitative requirements for RMT –** the current requirement to scale down the risk mitigation impact of a reinsurance contract in cases of SCR breach should be removed, not least because it is not practically applicable as information on SCR breach by a counterparty is not available.
- **Finite reinsurance –** it should be appropriately treated as a risk-mitigation technique, in line with the reality of the risk transfer involved.
- **Adverse Development Covers –** the associated reduction in SCR should be recognized as it corresponds to a true reduction of reserve risk.
- **Rolling of derivatives –**the requirement to not replace risk-mitigation techniques more often than every 3 months should be removed. In practice, more frequent rolling programmes could reduce basis risk and be less costly.
- **Credit risk derivatives –** the framework should improve the current recognition of credit risk derivatives used for hedging, by reviewing the unnecessarily stringent requirements around basis risk.
- **Profit and loss transfer agreements -** such agreements between insurers and their parent companies should be classified as a risk-mitigating technique and the impact recognised.

5. Volume measure for premium risk

The current approach for measuring premium risk needs improvements to take on a number of issues.

- Current premium measurement has flaws but EIOPAs proposed change would lead to an exaggeration of premiums. Insurance Europe has proposed simple improvements which should be tested.
- Asymmetric treatment of capital requirements and future profit recognition – currently the expected profit priced into the future premiums is ignored, overstating the capital charge and leading to perverse incentives. Insurance Europe proposes an improvement which should be tested.

6. Assessment of the appropriateness of standard parameters for non-life premium and reserve risks and for medical expense risk.

Insurance Europe supports recalibration of the areas identified by EIOPA and does not see a need for recalibrations beyond this list. Insurance Europe currently does not see a need to change the parameters for the other lines of business than the ones identified by EIOPA.

7. Natural catastrophe risks

Insurance Europe believes there is scope to simplify the specifications and calculation of this sub-module, while maintaining an appropriate level of risk sensitivity. In its detailed response it proposes an alternative modelling approach which would better align the design of the standard formula to industry practice, as well as a number of practical simplifications to the current approach.

8. Man-made catastrophe risk

Insurance Europe supports and proposes a new modelling approach, which is consistent and homogenous across all lines of business and is calibrated to reflect a range of covers and legal frameworks for each jurisdiction.

9. Health catastrophe risk

Insurance Europe welcomes simplifications to this sub-module and notes that there are a number of challenges in the currently required calculations, which should be addressed.

10. Mortality and longevity risk

Insurance Europe welcomes recognition in the discussion paper that the current longevity shock of 20% across all ages is too onerous. It is important to consider the relationship between the way the best estimate is calculated (ie the mortality tables that are used) and the shock that is applied. When the best estimate calculations already include future mortality improvements, the stress level needs to be lower. In line with Lee and Carter's findings in their 1992 paper (Modelling and Forecasting US mortality) that mortality improvements trends differ per age group, Insurance Europe supports an approach that recognizes the differences across all ages. Equally important, the use of Undertaking Specific Parameters (USPs) should be allowed, for an appropriate modelling of longevity risk and/or mortality risk, especially when these are material.

11. USP and GSP on underwriting risks

Insurance Europe remains strongly supportive of the use of USPs which, together with the proportionality principle, are meant to ensure that Solvency II works for all companies, irrespective of their size (SMEs, monoliners). Insurance Europe is concerned by the restricted scope of USPs in terms of methods and areas of application as currently defined in the Delegated Regulation. It therefore believes that the scope should be enlarged and aligned to the Solvency II Directive, which only foresees limitations for market and counterparty default risk. In addition, Insurance Europe is concerned that in practice the application of USPs is often made significantly burdensome by the approval procedure, as well as by a number of data requirements – many of which deserve a careful reconsideration.

12. Counterparty default risk module

Insurance Europe notes that a number of elements in the module are overly complex and burdensome (eg delta SCR, calculation of LGD for groups of single name exposures, collateralised derivatives etc). It therefore supports simplifications, aimed at reducing the burden of calculations while remaining proportionate to the risk exposure and in line with the objectives of a risk-based framework.

13. Exposures to qualifying central counterparties and derivatives

Insurance Europe supports EIOPA's work aimed at ensuring a better interaction between Solvency II and EMIR provisions, as well as a better reflection of significantly lower risk exposures that insurers are facing when investing in derivatives, as a direct consequence of the G-20 OTC derivatives reform and its European implementation, ie EMIR.

Specifically, with regard to derivatives cleared by a CCP, Insurance Europe believes that the risk exposure should be zero and should therefore trigger no capital requirement. Similarly, the treatment of exposures to OTC derivatives should be reviewed, to reflect not only significantly higher expected recovery values in case of default, but also the calibration of collateral haircuts in EMIR.

14. Assumptions of the market concentration risk sub-module

Insurance Europe has identified a number of difficulties and inconsistencies, in particular in relation to the applicability of the requirements related to single name exposures (eg determining the single name when single name exposures include at the same time insurance undertakings, credit institutions, or other financial institutions). In its detailed response, Insurance Europe is seeking for a range of clarifications and improvements in the current provisions.

15. Currency risk

Insurance Europe reiterates that the existing calibration of the currency risk charge in the standard formula incorrectly treats FX translation risk and incentivises poor risk management. This is an issue for both group entities and solo entities which conduct business in foreign currencies. Insurance Europe proposes improvements to the methodology which would enable insurers to operate sound risk management strategies without undue capital charges.

16. Look-Through approach

Insurance Europe supports the extension of the application of look through to investment related undertakings that are used as investment vehicles by insurers. This would ensure a more tailored capital requirement of these vehicles, better aligned with underlying risks. A review of the 20% level of assets for which a simplified approach may be applied should be undertaken, and the calculation changed so that assets backing unit/index linked funds should be excluded from the calculation. In addition, Insurance Europe highlights that the current wording regarding the availability of a fund's target asset allocation is often not workable in practice and other proxies for the asset allocation should be accepted.

17. Interest-rate risk

Insurance Europe believes that the interest rate risk methodology remains appropriate within the existing Solvency II framework and doesn't need changing. The current calibrations, while not perfect, should not give rise to prudential concerns, because the overall conservative design of Solvency II, compared to realistic cash flows, ensures insurers hold capital for extreme interest rate scenarios. In addition, key features of the methodology were designed in conjunction with other aspects of the framework and should not be considered in isolation or without impact assessment, and definitely not before the 2020 Solvency II review. In terms of calibration, it has to be noted that:

- interest rates should have a floor because insurers would seek alternatives if rates were significantly negative
- it is not plausible to assume that volatility observed at positive rates would be observed in equal measure when rates are negative
- it should be designed to be applied only to the liquid part of the term structure ie up to the last liquid point

18. Loss absorbing capacity of deferred taxes –

Insurance Europe does not support a default approach whereby the loss absorbing capacity of deferred tax (LAC DT) would be capped at the level of net deferred tax pre-shock (net DTL). This would go against the economic approach underpinning Solvency II and contradict the Framework directive and article 207 of the Delegated regulation which recognise, in full, the loss absorbency of deferred taxes so long as the undertaking can demonstrate credible future profits would be generated to make use of the assets or when the deferred tax assets which will reverse in the future without negatively impacting future taxable income. In this context, management actions after the shock, including recapitalisation (ie, receiving capital from a parent) should be given due consideration.

19. Risk margin

Insurance Europe believes the current method and assumptions for the risk margin are not appropriate as they lead to excessive levels of risk margin and volatility particularly for long-term insurance business, especially in this low interest rate environment. The need for the risk margin added to the liabilities should be re-examined, given that the MCR was also designed so that an entity can be taken over while there is still enough capital remaining to allow orderly sale/transfer/wind-up of the business with no loss to policyholders. Insurance Europe provides methods for improving the calculation of the risk margin in its detailed responses.

20. Comparison of own funds in insurance and banking sectors

Insurance Europe believes full alignment between insurance and banking regulations is not possible nor desirable as differences in business models between insurance and banking exist and justify differences in regulations. However, such differences should be analysed individually, as some issues would in fact deserve alignment of treatment between the two regimes. For example, while some of the differences regarding principal loss absorbency mechanisms (PLAM) between the two sectors are justified, unintended consequences for the write down/conversion mechanism should be addressed. Similarly, the differences in the treatment of applicable tax rules should also be investigated as Insurance Europe believes that these are not justified; specifically, while early call rights should be subject to prior regulatory approval, there should be no limitation on call rights.

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

Insurance Europe would not support the removal of the limit of 20% on the restricted tier 1 capital instrument as Restricted tier 1 is of weaker quality than Unrestricted tier 1 and should therefore remain limited. Moreover, adding more onerous requirements to improve the quality of restricted tier 1 to offset the removal of the limit is likely to effectively prohibit most insurers from issuing Tier 1 in the form of subordinated debt (market acceptance) and will increase the cost of such instruments.

Insurance Europe appreciates that all the sections under discussion require more detailed discussion and work in the coming months. It therefore looks forward to further engagement opportunities with EIOPA on the above issues.

More detailed responses can be found in Insurance Europe full submission (see here).

Insurance Europe is the European insurance and reinsurance federation. Through its 35 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 200bn, directly employ over 985 000 people and invest nearly €9 900bn in the economy.