EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

LTG Measures: transitional measures, risk-management provisions and disclosure

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on the transitional measures, risk-management provisions and disclosure. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II rules. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and Insurance Guarantee Schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**). This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of topics as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own Funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

Milliman has produced a briefing note giving a summary of EIOPA's proposals in the CP (available here) and separate briefing notes covering each of these topics in more detail. This briefing note covers the transitional measures as well as the risk-management provisions and disclosures on LTG measures under the LTG and equity risk measures section. LTG measures refers to the Matching Adjustment (**MA**), the Volatility Adjustment (**VA**) and the transitional measures.

Transitional Measures

The Solvency II Directive allows for the use of transitional measures by undertakings within the scope of Solvency II. There are two transitional measures covered within this section of the review. These are:

- The transitional measure on the risk-free interest rates, which allows for a phasing in of the discount rate used in the Solvency II calculations
- The transitional measure on technical provisions, which allows a deduction to the value of the technical provisions to phase in the difference in the value of the liabilities under Solvency II relative to the previous regulations

EIOPA has stated that the objectives of the transitional measures are to:

- Allow for a smooth transition to Solvency II from the prior regulatory regimes
- Avoid market disruption and limit interference with existing products, as well as ensuring the availability of insurance products
- Encourage compliance with the Solvency II requirements as soon as possible

As part of the 2020 Review the transitional measures (both the transitional measure on the risk-free interest rates and the transitional measure on technical provisions) are being considered by EIOPA. As part of its review EIOPA identified three particular areas for consideration in relation to the application of transitional measures. These are:

- The predominant application of the transitional by firms that did not have a capital gap[2]

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive

[2] The capital gap is the amount by which the company's Own Funds fall short of covering 100% of the SCR. There is no capital gap if the Own Funds exceed the SCR.

- Approval of transitionals after 1 January 2016, the Solvency II implementation date
- The interaction of capital add-ons and the transitionals

APPLICATION OF TRANSITONALS WITHOUT CAPITAL GAP

Analysis performed by EIOPA on data as at the end of 2017 indicates that the transitionals are predominately used by firms that do not have a capital gap i.e. by firms that are able to cover their SCR without the use of transitionals.

EIOPA surmises that the use of transitionals by companies without a capital gap contradicts the objective to encourage compliance with Solvency II as soon as possible and highlights some negative consequences of unnecessary application of the transitionals. This includes the fact that the technical provisions are not valued in line with Solvency II principles, which could distort the firm's reported solvency position and create a disparity between firms that do and do not apply the transitionals.

To counteract these issues, EIOPA has put forward a number of potential solutions[3] but its preferred approach is to increase the disclosure requirements in respect of the use of transitionals, in particular:

- The Solvency and Financial Condition Report (**SFCR**) should set out reasons for the use of the transitional. Where the firm would not be able to cover its SCR without the transitional this would be viewed as sufficient justification. Where the firm is able to cover its SCR without the transitional other reasons should be provided.
- The SFCR should include an assessment of the firm's dependence on the transitional and how it intends to remove such dependency by the end of the transitional period.
- The proposed policyholder section of the SFCR should include:
  - The impact of the transitional on the firm's solvency coverage
  - The reasons for applying the transitional
  - The likelihood of reducing the dependence on the transitional by the end of the transitional period

If the proposals on disclosure of the transitionals come into force they will require additional work from firms to ensure that the requisite information is included within their SFCR. Given that firms do not currently have to justify their use of the transitional this could present a challenge if firms do not have sufficient reason to justify their use beyond, for example, improving the solvency position. This could result in firms deciding to no longer use the transitionals or having their approval to use them revoked. However this proposal would improve the level of disclosure of the impact of the transitionals to the firm's policyholders.

APPROVAL OF NEW TRANSITIONALS

EIOPA has identified a lack of harmonisation with respect to National Supervisory Authorities' (**NSA**) approaches to approvals of transitionals after 1 January 2016, the Solvency II implementation date.

EIOPA proposes that (re)insurers should only be allowed to start applying transitionals if:

- The (re)insurer passes the threshold of the Solvency II Directive Article 4 meaning that it newly falls under the scope of Solvency II, or
- The firm receives a transfer of a portfolio of business that is already subject to the transitionals of another firm.

This proposal would mean that firms would not be able to apply to use the transitionals to alleviate solvency issues that have emerged post-transition to Solvency II. Firms that meet the two criteria outlined by EIOPA will still be able to apply for a new transitional.

CAPITAL ADD-ONS AND TRANSITIONALS

Firms that are unable to cover their SCR without transitionals currently need to submit a phasing-in plan to their NSA on how they intend to cover their SCR by the end of the transitional period and provide regular updates on their progress against their plans. NSAs may revoke the transitional approval if it is unrealistic that the firms will be able to cover their SCR by the end of the transitional period.

NSAs may also set a capital add-on where a firm's risk profile deviates significantly from the assumptions underlying the SCR.

EIOPA proposes a clarification to ensure consistent application of capital add-ons and allow NSAs to apply a temporary capital add-on where a firm has provided an unrealistic phasing-in plan but the NSA believes that there is a different phasing-in plan that would be more realistic. The same application could also be made where the phasing-in plan becomes unrealistic over time and an update to the plan is requested by the NSA.

This proposal is a clarification of the existing rules and could lead to a capital add-on being applied where the NSA views that a firm's phasing-in plan as unrealistic.

[3] The potential solutions identified are to:
- Restrict the use of transitionals
- Limit the impact of transitionals for companies without a capital gap
- Strengthen the disclosure on transitionals
- Extend the use of phasing-in plans to all firms depending on transitionals

Risk-management provisions on LTG measures

As part of the 2020 Review, EIOPA has reviewed the risk-management provisions on LTG measures. This is part of EIOPA's wider review of LTG measures.

EIOPA has previously assessed the adequacy of risk management requirements on the LTG measures as part of its LTG Report 2018[4]. This highlighted a number of issues, which EIOPA have now provided feedback on and recommendations of how to improve risk management relating to LTG measures going forward. The issues highlighted and EIOPA's subsequent proposals are discussed in the following sections.

ROLE OF LIQUIDITY PLAN FOR THE VA

Solvency II requires firms using the VA to create a liquidity plan projecting the asset and liability cashflows that are subject to the VA. EIOPA has identified that although there is clear benefit to proper liquidity planning, that it is unclear:

- What the expectations of this liquidity plan specific to the VA are
- What additional insight the VA liquidity plan should be giving on the cashflows subject to the VA
- What role this liquidity plan should play in the application of the VA to the business
- How the liquidity plan analysis should be documented or even if it should

To address this, EIOPA proposes to clarify and strengthen the requirements, such that companies applying the VA no longer require a separate liquidity management plan for the VA, but that their existing liquidity plan must take into account the VA. In particular, firms should analyse if there are any liquidity constraints which are not in-line with the application of the VA.

This may involve some additional work for firms due to the enhanced requirements for the liquidity plans. The new requirements may also limit the firm's use of the VA.

SENSITIVITY ANALYSIS FOR THE VA

Solvency II requires firms using the VA to assess the sensitivity of the Technical Provisions and Own Funds to the assumptions underlying the VA calculation and to provide this analysis to its NSA annually. EIOPA notes that in practice most firms are not reporting these assessments with reasons for this being that it was not clear:

- What assumptions were underlying the VA
- What the benefits of this analysis were
- How it should be reported

EIOPA proposes to change the requirements to refer to sensitivities under different economic situations rather than the assumptions underlying the VA. EIOPA also proposes that the outcome of this analysis should be reported within the Regular Supervisory Report (**RSR**).

This proposal should make it easier for firms to complete the requisite assessment, however it may increase the reporting burden of the RSR for most firms given that the majority of firms are not currently reporting this assessment.

FORCED SALE OF ASSETS FOR THE MA AND VA

Solvency II requires firms using the MA and VA to assess the possible effects of a forced sale of assets on their Own Funds. EIOPA observes that in practice firms using the VA did not generally report on this. For firms using the MA a report was also generally not made, but instead a declaration that forced sales could not result in losses for the firm was made due to the requirements on the use of the MA.

In response to this EIOPA proposes to remove the requirement to report on the possible effects of a forced sales of assets for firms using the MA and VA.

This proposal reduces the reporting burden on firms minimally but is likely to be welcomed by firms given the large reporting burden of Solvency II.

POLICY ON RISK MANAGEMENT FOR THE VA

Solvency II requires firms using the VA to include, within their risk management policy, the criteria for the application of the VA. The feedback received by EIOPA suggested firms were not clear on the exact requirements in relation to this criteria.

EIOPA proposes to clarify the requirement by replacing it with a more general requirement, requiring firms to reflect on their use of the VA within their risk management policy.

This proposal should make meeting this requirement easier for firms to comply with as firms no longer need to focus on the criteria required for the VA, but rather only on the firm's use of the VA.

ANALYSIS OF MEASURES RESTORING COMPLIANCE

Solvency II requires that in circumstances where the reduction of the MA or VA to zero would result in a firm being unable to cover its SCR, firms must submit an analysis of the measures that could be taken to increase the level of Own Funds or reduce the level of the SCR to restore compliance. No similar analysis is currently required for the transitionals or where a more market-consistent extrapolation of the interest rate term structure results in a firm being unable to cover its SCR.

To counteract this issue, EIOPA proposes to enhance the current requirements to be such that if the removal of the MA, VA and the transitionals, as well as using a more market-consistent extrapolation of the interest rate term structure[5] ,

[4] LTG Report 2018

[5] This refers to an extrapolation using the last point at which there is a deep, liquid and transparent swap maturity as the last liquid point and decreasing the Ultimate Forward Rate by 100 bps.

resulted in a firm being unable to cover its SCR, firms should report to its NSA that any dividend payments or capital distributions made will not put the protection of policyholders at risk. The NSA would then have the power to limit or prevent the capital distributions where they felt this was necessary. Firms should report this information to their NSA regularly.

The enhanced requirements will increase the power of the NSAs to limit or prevent capital distributions for firms using LTG measures or transitionals where this would put policyholder protection at risk.

Disclosure on LTG measures

As part of EIOPA's review of LTG measures within the 2020 Review, the adequacy of firms' disclosures on LTG measures and the transitionals has been assessed. EIOPA noted that NSAs are generally satisfied with the level of information disclosed, but that there is some variation between firms. Some stakeholders were interested in more detailed information in more readily available formats.

EIOPA has identified a number of issues, including:

- A lack of qualitative information
- Insufficient quantitative information, particularly with regard to the impact of the LTG measures on the SCR, MCR and solvency coverage ratios
- Lack of disclosure of sensitivity analysis on the LTG measures or extrapolation of the risk-free interest rates

EIOPA proposes actions to improve the disclosure on LTG measures and address some of the issues identified. EIOPA recommends:

- Defining minimum information disclosure requirements on the use of LTG measures. Consideration should be given to the disclosure of the impact of the LTG measures within the policyholder section of the SFCR.
- Including the impact of the LTG measures on the SCR and MCR coverage ratios within QRT S.22.01. The impacts can be calculated from information already contained within the QRT.
- (Re)insurers should include sensitivity analysis within the SFCR on the ultimate forward rates (**UFRs**) used in the extrapolation of the risk-free interest rates. The sensitivity would show the impact of a downward shift in the UFR of 100bps on the Technical Provisions, SCR, MCR, Basic Own Funds and Own Funds eligible to cover the SCR and MCR.

Some of the areas lacking in quantitative information will be covered via additional EIOPA guidelines in the future, and as such no guidance has currently been provided.

The proposed changes with regard to disclosure on the LTG measures will increase the amount of work required in preparing a firm's SFCR, in particular the running of the additional sensitivity on the UFR. Firms will also need to ensure that any software used to populate QRTs is adjusted to allow for the additional lines that would be required within QRT S.22.01.

The increased level of disclosure will be of benefit to different stakeholders such as policyholders, particularly the sensitivity analysis of the UFR which can have a material impact on the solvency coverage for some companies.

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