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

Minimum Capital Requirement

Milliman

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 Minimal Capital Requirement (MCR). 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 Directive. 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 topics related to the Minimum Capital Requirement (MCR).

Minimum Capital Requirement (MCR)

This briefing note provides a summary of the opinion provided by EIOPA regarding the Solvency II 2020 review on the following topics:

- Calculation of the MCR: This relates to the use of caps and floors; consistency of the calculation of the MCR with an 85% VaR of the basic own funds over a one year period; and identification of eligible basic own funds items for life and non-life activities of composite undertakings
- Non-compliance with the MCR: This relates to the clarification of wording in relation to non-compliance and the risk of non-compliance; supervisory actions taken in case of likely non-compliance; practices for restriction or prohibition of the free disposal of assets; and the process of licence withdrawal and post-withdrawal supervision

CALCULATION OF THE MCR

Use of caps and floors

EIOPA advises not to change the current 25%-45% floor-cap corridor.

According to the survey run by EIOPA amongst the National Supervisory Authorities (NSAs), only 25% of all undertakings in the EEA base their final MCR figures on the linear MCR, while 26% of all undertakings use 25% SCR floor, 18% use 45% SCR cap and 30% use the absolute floor (all figures are based on solo YE 2018 reporting).

The 25%-45% corridor was originally built around 35%, which was considered as a proxy broadly consistent with the ratio of the 85% own fund VaR to 99.5% own fund VaR for the range of the distributions used in the Standard Formula SCR.

While the usage of the absolute floor is not unexpected for small undertakings, the wide application of caps and (non-absolute) floors could indicate that the probability distribution

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

underlying the calculation of the SCR departs from the hypotheses underlying the 35% proxy.

EIOPA considered enlarging the 25%-45% corridor to a 20%-50% interval, or replacing the capped linear MCR with the maximum of 35% SCR and the absolute floor. The first option would ensure a wider use of linear MCR thus better reflecting the actual risk profile, the second would increase the homogeneity of the results. Ultimately EIOPA states that it sees no reason to change the current 25%-45% corridor.

Consistency of MCR with 85% VaR

EIOPA recommends changing the risk factors for the calculation of the MCR set out in Annex XIX of the Delegated Regulation as follows:

Segment	Factor for technical provisions	Factor for premiums written
Credit & surety	16.0%	17.7%
Legal exp.	5.2%	7.8%
Assistance	20.3%	6.0%
Accident	5.4%	No change
Sickness	No change	8.0%
Workers comp.	10.3%	9.0%
NPR health	15.9%	No change

The life SCR calculation has not been heavily impacted by the 2018 review changes and therefore EIOPA sees no reason for the MCR calculation to no longer be consistent with 85% VaR of the basic own funds over a one-year period.

For the non-life MCR however, the alpha and beta parameters in the linear MCR formula are directly linked to the sigma parameters for premium and reserve risks. Since the 2018 review has led to changes in the standard deviation (sigma) parameters for some segments, the corresponding alpha and beta parameters needed to be updated. To this end EIOPA recalibrated the alpha and beta parameters for the abovementioned segments. The results are presented in the table above.

Potential issues with regard to the identification of eligible basic own funds items for composite undertakings

EIOPA advises no change to the current calculation of notional MCRs with respect to potential issues related to the identification of eligible basic own funds items for composite undertakings.

EIOPA notes that while composite undertakings have to report notional life and non-life MCRs, the Solvency II regulations do not define the eligible own funds, that are available for each of the activities. Moreover, the calculation of the global MCR of the composite undertaking is not based on these notional MCRs, but calculated as a whole as for any other undertaking.

This limits the value of the notional life and non-life MCRs for the supervisory purposes and therefore EIOPA considered either removing the notional MCRs reporting requirement or defining precisely which own funds should be allocated to the life and non-life sides. Ultimately the advice is not to change the current calculation and reporting process to continue to allow a view of both a life and non-life MCR.

NON-COMPLIANCE WITH THE MCR

Qualification of non-compliance with MCR

EIOPA recommends to strengthen the clarity of what is meant by ‘immediately’ and ‘observed’ in the Article 139(1) of the Solvency II directive by including the additional text underlined below:

“Insurance and reinsurance undertakings shall inform the supervisory authority immediately <u>and not in the quarterly reporting as specified in Article 129(4)</u> where they observe that the Minimum Capital Requirement is no longer complied with, <u>even if the exact level of non-compliance is not yet determined</u> or where…..”

EIOPA also advises that further guidance in Level 2 or Level 3 should be provided for what is ‘observed’ in order to have this information exchanged at an early stage.

EIOPA notes that, while all insurance undertakings are expected to report the level of MCR quarterly to NSAs, the “observed” non-compliance requires (under the Article 139(1) of the Solvency II Directive) the firm to immediately inform the NSA. Both “immediate” and “observed” are subject to different practices and expectations from various NSAs. Some NSAs leave the timing to report MCR non-compliance at the discretion of the insurance undertakings, while others expect to be informed at a much earlier stage.

The ambiguity of ‘observed’ also results in different practices, as it could be interpreted as being the moment when the exact levels of all balance sheet items are fully assessed, or at an earlier stage when the insurance undertaking is aware that a given loss situation may lead to a non-compliance without being able to fully assess its exact level.

EIOPA concludes that if more consistent policyholder protection is to be achieved then more common regulation would be appropriate and advises amending the Solvency II directive as indicated above.

Qualification of risk of non-compliance with MCR

EIOPA recommends no changes to Article 139(1) of the Solvency II Directive but advises that it will further elaborate on the expectations from NSAs to insurance undertakings on information to be provided to the NSA when there is a risk of a breach of the MCR.

In addition to actual non-compliance, insurance undertakings are obliged (under the Article 139(1) of the Solvency II Directive) to inform the NSA if they see a risk of non-compliance with the MCR in the next 3 months. EIOPA notes that supervisory practice shows very limited reporting of this issue and quite diverse approaches as to when NSAs would expect such reporting. Most NSAs do not have any further guidance or expectations on what would constitute a risk of non-compliance with the MCR, however some NSAs use on-site inspection outcomes, ORSA projections, fixed MCR coverage thresholds or SCR non-compliance as triggers.

EIOPA observes that the lack of common supervisory practice in this matter and the relatively limited use of MCR non-compliance risk notification could jeopardise the overall aim of having more time to remedy the financial situation to the benefit of policyholders.

EIOPA advises no change to the Article 139(1) of the Solvency II Directive but concludes that in order to have a more common understanding of what is meant by the risk of non-compliance, it would be appropriate to indicate the type and level of risks to be assessed by NSAs when there is a risk of a breach of MCR.

Supervisory actions in case of likely MCR non-compliance

EIOPA advises to amend Article 139(2) of Solvency II Directive by including the additional text underlined below:

Within one month from the observation of non-compliance with the Minimum Capital Requirement <u>or from the observation of risk of non-compliance</u> ...“

EIOPA also advises that further L2 or L3 guidance should be provided on the minimum content of ”the short-term realistic finance scheme“ as well as minimum actions to be taken in addition to just approving/disapproving the short-term realistic finance scheme.

Article 139(2) of the Solvency II Directive requires insurance undertakings to submit to the NSA a realistic finance scheme to restore (either through increasing basic own funds or de-risking) MCR compliance within 3 months from the observation of the non-compliance. The scheme has to be submitted within one month of the observation of the MCR non-compliance and is subject to NSA approval.

EIOPA notes that while Article 139(2) sets out explicit requirements in case of observed non-compliance, it is more up to national discretion which activities, plans and deadlines have to be in place when there is only a risk of non-compliance with MCR within the next three months. As a result there is a wide range of approaches, with some NSAs holding on-site meetings with insurance undertakings to better understand the economic situation, some requesting more frequent reporting (e.g. monthly instead of quarterly) and some requesting a finance scheme similar to the one required in case of observed non-compliance.

For those NSAs requesting a finance scheme it is also noted that only a few have defined what elements should be part of the finance scheme.

EIOPA concludes that if more consistent policyholder protection is to be achieved then more common regulation would be appropriate and advises amending the Solvency II directive as indicated above.

Practices for restriction or prohibition of the free disposal of assets

EIOPA advises to amend Article 139(3) of the Solvency II Directive by replacing *“The supervisory authority of the home member state may also restrict or prohibit the free disposal of the assets”* with *“If a winding-up procedure is not opened by the supervisory authority of the home member state, it shall within two months of being informed following paragraph 1 decide if or if not in the interest of policyholder protection to restrict or prohibit the free disposal of the assets”*

Under Article 139(3) NSAs “may” prohibit the free disposal of assets, and while NSAs do not in general observe many practical complications with regards to the use of this instrument only very few of them have actually applied it in the case of non-compliance, or a risk of non-compliance, with the MCR.

The amendment proposed by EIOPA sets a clearer timeline for reaching a decision concerning potential free asset disposal restrictions.

Withdrawal of license processes

EIOPA advises to amend Article 144(1) of the Solvency II Directive by specifying a maximum time (three months) for restoring MCR compliance, or by specifying in which situation this can be extended. EIOPA also recommends specifying if new policyholders can be put at risk during the extended period (i.e. whether the insurance undertakings can continue to underwrite business).

EIOPA further notes that alternatives to specifying the conditions for extensions can also by developed (e.g. by letting EIOPA decide on any such points, particularly for insurance undertakings with cross border business).

According to Article 144 of the Solvency II Directive the authorisation should be withdrawn in cases when the insurance undertaking does not comply with the MCR within three months of the first observation of non-compliance, when the NSA considers the finance scheme manifestly inadequate or when the insurance undertaking fails to comply with the NSA approved scheme.

Most NSAs consider the three months as the absolute maximum time limit for restoring MCR compliance, some however would be willing to consider extending this period under special circumstances such as an open appeal or hearing process extending beyond three months, appointing an administrator that would eventually oversee the process of transferring the portfolio to a third party, or not being in a position (on the part of NSA) to finally conclude that the finance scheme is manifestly inadequate after the said three months.

EIOPA notes that a few NSAs allow the undertakings to continue conducting their business after the three months but restrict the insurance undertakings from doing new underwriting.

The different practices of NSAs for withdrawal of authorisation gives policyholders different levels of protections which led EIOPA to recommend amending Article 144 of the Solvency II Directive as indicated above.

Supervision by NSAs after license withdrawal

EIOPA advises to amend Article 144 of the Solvency II Directive to specify the obligations of an insurance undertaking whose license has been withdrawn (i.e. in cases where insurance undertakings are not in wind-up following Chapter III of Solvency II Directive). EIOPA also recommends clarifying that the exiting NSAs continue to have a mandate to supervise such undertakings.

In cases where the non-compliance with MCR and a subsequent withdrawal of license are further followed by an ultimate winding-up proceeding, the provisions of Chapter III of the Solvency II Directive apply. However, when a winding-up proceeding is not taking place, the supervisory practices are not aligned. An example of such a situation is when an insurance undertaking is only restricted from conducting new business while being in “run-off” (i.e. run-off without compliance with the MCR).

Most NSAs consider such run-off insurance undertakings to be under their supervision even after the authorization is withdrawn, however a few NSAs have informed EIOPA that they do not have a mandate to supervise such undertakings.

EIOPA recommends clarifying that NSAs continue to have a supervision mandate after the license withdrawal and to specify the obligations of the undertakings in cases when winding-up proceedings are not taking place.

Milliman is among the world’s largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

Milliman maintains a strong and growing presence in Europe with 250 professional consultants serving clients from offices in Amsterdam, Brussels, Bucharest, Dublin, Dusseldorf, Isle of Man, London, Luxembourg, Madrid, Milan, Paris, Warsaw, and Zurich.

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CONTACT

WARSAW

Jaroslaw Lech
jaroslaw.lech@milliman.com

PARIS

Veille Réglementaire
veille.reglementaire@milliman.com