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

Proportionality

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 Proportionality. 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 the proposals in regard to proportionality.

Proportionality

As an overarching principle of Solvency II, the proportionality principle means that Solvency II requirements should be proportionate to the nature, scale and complexity of the risks faced by individual companies.

EIOPA has been asked whether proportionality in the application of the Solvency II framework could be enhanced, in particular in the following areas:

- methodology and thresholds determining exclusion from the scope of Solvency II
- simplified calculation of SCR sub-modules for risks that are immaterial (in the case of an individual company)
- waiver of certain requirements relating to any of the three pillars of the framework (based on size thresholds, the nature of the company or its risks)

EIOPA has considered input from the industry received over the last few years, including dedicated papers and opinions on proportionality. EIOPA notes that some market commentators are unsatisfied with how proportionality is currently addressed under the legislation (and implemented by national supervisors), and notes how commentators see an urgent need for improvement.

EIOPA agrees that the proportionality principle should be assessed and revised, but also believes that to promote a proper and fair review it is important to fully understand the application of the proportionality principle as currently implemented.

Within the CP, EIOPA then proposes proportionality-related changes in the areas set out below.

EXCLUSION FROM SOLVENCY II

Article 4 of the Solvency II Framework Directive defines those insurance companies that can be excluded from the scope of Solvency II. Exclusion is determined in line with thresholds

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

based on business volumes – for example, annual gross written premium income lower than €5 million, or gross technical provisions lower than €25 million.

The prudential regime that applies to undertakings excluded from Solvency II varies by member state. Typically it is Solvency I, an amended version of Solvency II or a pre-existing regime.

EIOPA considered potential changes to this approach, including the possibility of introducing a specific supervisory regime for medium-sized companies. In conclusion however EIOPA proposes not to change the basic approach used to determine exclusion from Solvency II.

EIOPA has then considered changes to the threshold amounts of the current approach and concludes that these can be raised.

EIOPA also proposes that discretion be introduced to allow member states to set the premium income threshold. EIOPA believes that the threshold for technical provisions should not involve such discretion however, noting that technical provisions represent the first line of defence for policyholder protection.

In conclusion, the technical provisions threshold is therefore proposed to increase from €25 million to €50 million, while EIOPA proposes to allow member states the option to set a premium income threshold higher than the current €5 million up to a maximum of €25 million.

CALCULATION OF TECHNICAL PROVISIONS

EIOPA has considered proportionality in relation to the determination of technical provisions and is not currently proposing any changes.

EIOPA notes that the principle-based nature of the calculation of technical provisions already implicitly incorporates proportionality.

However, at the same time EIOPA has asked for "concrete proposals" from stakeholders on what changes might perhaps be necessary to improve the proportionality of the requirements.

CALCULATION OF SCR

EIOPA is considering introducing further simplifications to the standard formula SCR calculations, and especially for the calculation of capital requirements when the corresponding risks are in fact immaterial for a particular company.

EIOPA has set out two proposed options for such simplification, and asks stakeholders to note which one they prefer:

- Introduce a set of specific simplifications available within the calculation of capital requirements for when risks are immaterial
- Introduce an overall approach to immaterial risks that facilitates simplified calculation of the capital requirement relating to these risks

EIOPA notes that it currently has no preference between these two options. However, both are considered by EIOPA to be preferable to no change at all being made.

The first option would effectively involve taking any existing capital requirement (relating to a risk that is immaterial) and replacing it with a simplified capital requirement that is easy to calculate, risk-sensitive and of similar size to (and no less than) the original amount.

An example of this type of simplification might be to group exposures and then simply use the highest risk parameter(s) found within the group.

Another example of such a simplification might be where the impact of a risk-mitigating technique is simply taken to be zero, or where no diversification benefit is assumed.

The second option being considered involves an integrated approach to calculating the capital requirement relating to immaterial risks. This approach would follow three basic steps:

- Step 1 – identification of all immaterial risks from the BSCR calculation (with an "immaterial risk" making up less than x% of the BSCR, and the sum of all immaterial risks being less than y% of the BSCR, with x and y as yet undefined)
- Step 2 – derivation of the SCR relating to immaterial risks via a new calculation of the BSCR that excludes those risks identified in Step 1
- Step 3 – reassessment (e.g. every three years) of the immateriality of the risks identified in Step 1

PILLAR II ASPECTS

KEY FUNCTIONS

EIOPA proposes that the following situations be permitted, if justified under proportionality:

- A person may be responsible for a key function and also be a board member
- A single person may be responsible for more than one key function
- A single person may be responsible for operational functions and also for a key function (except the internal audit function)

THE BOARD

EIOPA proposes that companies regularly assess the composition and effectiveness of the Board.

EIOPA notes that this assessment should take into account proportionality.

OWN RISK AND SOLVENCY ASSESSMENT (ORSA)

EIOPA proposes that the assessment of deviations of the risk profile of the company from the assumptions underlying the standard formula does not need to be included in the annual ORSA. Instead this assessment can be provided every two years (but must also be provided following any significant change in the risk profile).

EIOPA is also proposing that the complexity of stress tests and scenario analysis in the ORSA can take into account proportionality.

WRITTEN POLICIES

EIOPA is proposing to relax the current requirement to review written policies annually, taking into account proportionality by allowing less frequent review (up to every three years).

REMUNERATION

With regard to the current requirement to defer a substantial portion of variable remuneration, EIOPA proposes to limit this requirement, taking into account the size of the company and the amount of the variable remuneration in question.

EIOPA notes that it is in the process of finalising an opinion on the supervision of remuneration principles in the insurance and reinsurance sector following consultation earlier this year.

Summary

In summary, EIOPA is proposing some changes to address input received from the industry on proportionality. Whilst the changes proposed here will be welcomed, on balance, taking into account other changes proposed by EIOPA as part of the 2020 review, it is unlikely that commentators will be satisfied that the steps taken to address proportionality concerns are adequate.

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