28 November 2019

Workshop on the 2020 review of Solvency II

6 December 2019

Agenda

Venue: EIOPA, Westhafenplatz 1, 60327 Frankfurt am Main

Time schedule: 6 December, 9:30 - 17:15

Meeting Room: 28/001

09:00	Registration
09:30	**Welcome** EIOPA
09:40	**2020 review of Solvency II - next steps** EIOPA
10:00	**Extrapolation of risk-free interest rates** DNB, CRO Forum/CFO Forum
10:45	**Volatility adjustment** BaFin, Insurance Europe & AMICE
11:45	**Risk margin** EIOPA, CRO Forum/CFO Forum
12:30	Lunch
13:15	**Equity risk** EIOPA, AMICE
13:55	**Property risk** EIOPA, Insurance Europe
14:25	**Interest rate risk**

	IVASS, Insurance Europe
14:55	Coffee break
15:10	**Non-proportional reinsurance** EIOPA, Insurance Europe Reinsurance Advisory Board (RAB)
15:40	**Proportionality** EIOPA, FERMA, AMICE
16:15	**Other review topics**
17:00	**Wrap-up**
17:15	Scheduled end of meeting

For each topic, presentations from speakers will be followed by open debate

2020 review of Solvency II
Next steps

Workshop on 2020 review
Frankfurt, 6 December 2019

2020 review of Solvency II

Call for Advice of the European Commission

Advice requested on ...

- Long-term guarantees (LTG) measures
- Transitional measures
- Risk margin
- Capital Markets Union
- Dynamic volatility adjustment
- SCR standard formula
- Risk-mitigation techniques
- MCR
- Macro-prudential issues
- Recovery and resolution
- Insurance guarantee schemes
- FoS and FoE insurance
- Group supervision
- Reporting and disclosure
- Proportionality
- Best estimate
- Own funds
- Reducing reliance on external ratings

Deadline: 30 June 2020

EIOPA deliverables for 2020 review:

- Annual LTG reports 2016 to 2020
- Response to COM's Call for Information on asset-liability management
- **Opinion on 2020 review**

2020 review of Solvency II

Evolution not revolution

- 2020 review is broad, but will leave the fundamentals of Solvency II unchanged.
- European Commission: *"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)".*
- In line with our perception that introduction of Solvency II has largely been a success:
  - o Insurance industry has better aligned capital to the risks it runs.
  - o Risk-based approach to assess and mitigate risks.
  - o Governance models and their risk management capacity significantly strengthened.
  - o Insurers throughout Europe use harmonised templates for supervisory reporting, instead of a patchwork of national templates.

2020 review of Solvency II

Objectives of the review

- Calibration of interest rate risk which reflects economic reality
- Balanced updating of the current regulatory framework based on supervisory experience with the application of Solvency II provisions since 2016.
  - Consultation paper: “Beyond the changes on interest rate risk EIOPA aims in general for a balanced impact of the proposals.”
- Completion of the regulatory toolbox
  - Introduce macroprudential tools to Solvency II
  - Minimum harmonised recovery and resolution framework
  - Minimum harmonisation of insurance guarantee schemes

2020 review of Solvency II

EIOPA consultation paper

- Draft advice in public consultation from 15 October 2019 to 15 January 2020
- Consultation accompanied by information requests to industry and national supervisors
  - o Quantitative impact of proposals
  - o Cost and benefit of proposals
- Draft advice is preliminary - consultation will give EIOPA more insight from the market.
- EIOPA will continue analysis during and after the consultation, likely resulting in changes.
- Advice will be scrutinized through a holistic impact assessment.

2020 review of Solvency II

Workshop will feed into ongoing analysis of review topics, for example:

- VA – Simplification of application ratios
- Risk margin – Analysis of additional proposals to improve margin calculation
- Equity risk – Treatment of equity covering illiquid liabilities
- Property risk – Review of calibration in light of new data
- Non-proportional reinsurance – Additional efforts to better recognise it in the SCR standard formula
- Proportionality – Further analysis on application of proportionality principle in the supervisory review process taking into account stakeholder proposals

2020 review of Solvency II

Timeline

April 2018	EIOPA receives Call for Information on asset-liability management from the European Commission
Mid-July to mid-Oct 2019	Public consultation on draft advice on reporting and disclosure and insurance guarantee schemes
Mid-Oct 2019 to mid-Jan 2020	**Public consultation on draft Opinion (covering all advice other than on reporting and disclosure and insurance guarantee schemes)**
Mid-Oct to beginning of Dec 2019	**Information request to industry and national supervisors on impact of single proposals**
Dec 2019	**Publication of response to call for information and of LTG report 2019**
March 2020	**Information request on combined impact of proposals**
June 2020	**Publication of Opinion on 2020 review**

Extrapolation of risk-free interest rates

Workshop on 2020 review
Frankfurt, 6 December 2019

Extrapolation of risk-free interest rates

Four issues with current risk-free rates:

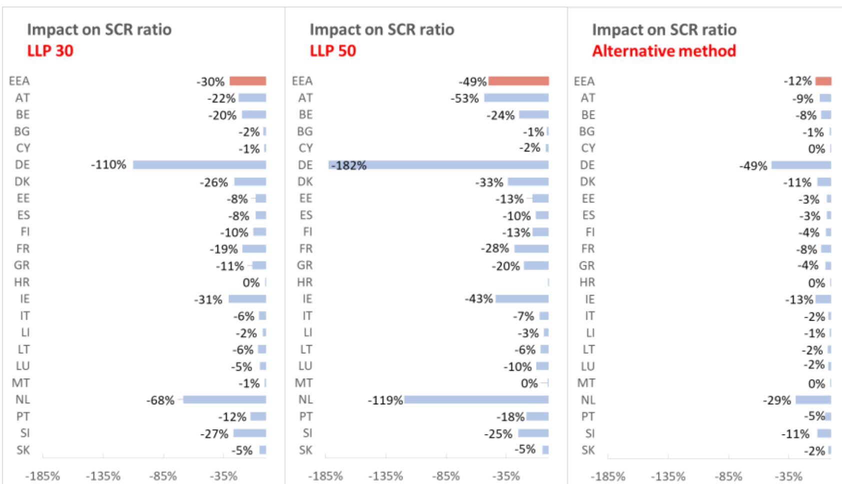
1. Underestimation of technical provisions
2. Risk management incentives
3. Stability of the solvency position and impact on financial stability
4. Evidence on DLT assessments

Five options regarding extrapolation:

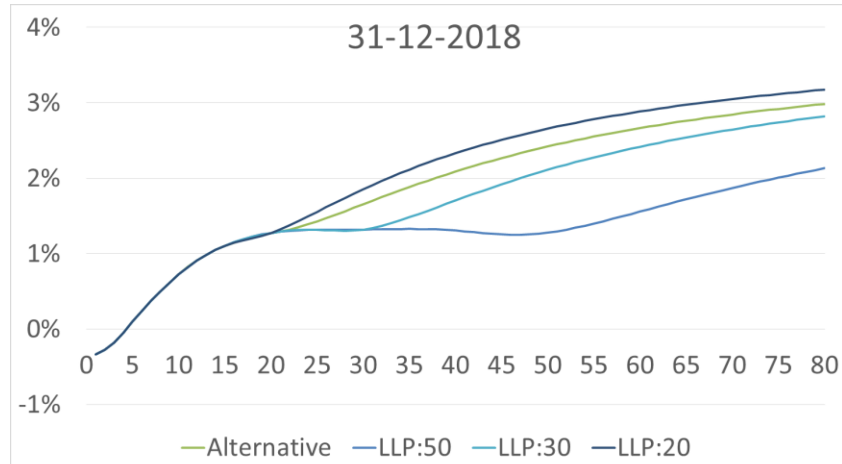
1. No change
2. The LLP stays at 20 years for the euro and additional safeguards are introduced in pillar 2 and 3
   - Next to reporting on cumulative impact of LTG measures add cumulative impact of extrapolation
   - If cumulative impact, including extrapolation, results in non-compliance with SCR, NSAs may require undertakings to demonstrate the sustainability of capital distributions; NSAs may limit those distributions if not convinced by the evidence provided by the undertaking
3. The LLP is increased to 30 years for the euro
4. The LLP is increased to 50 years
5. An alternative extrapolation method is adopted

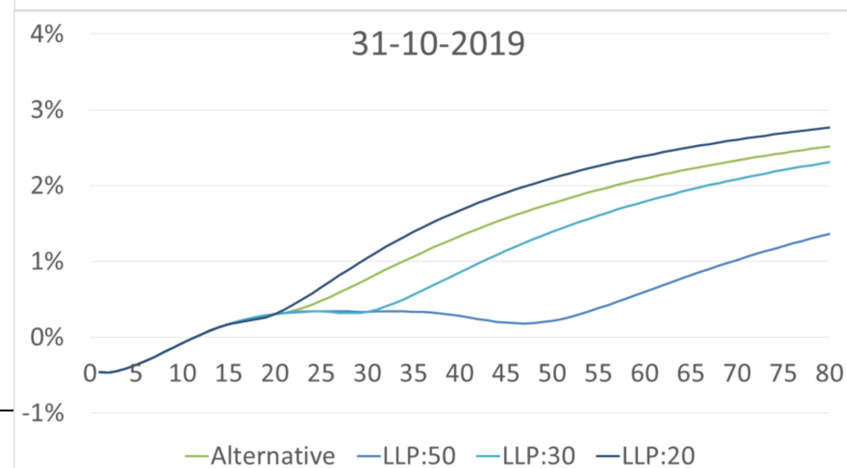
Extrapolation of risk-free interest rates

Impact per 31-12-2018



Impact depends on actual rates

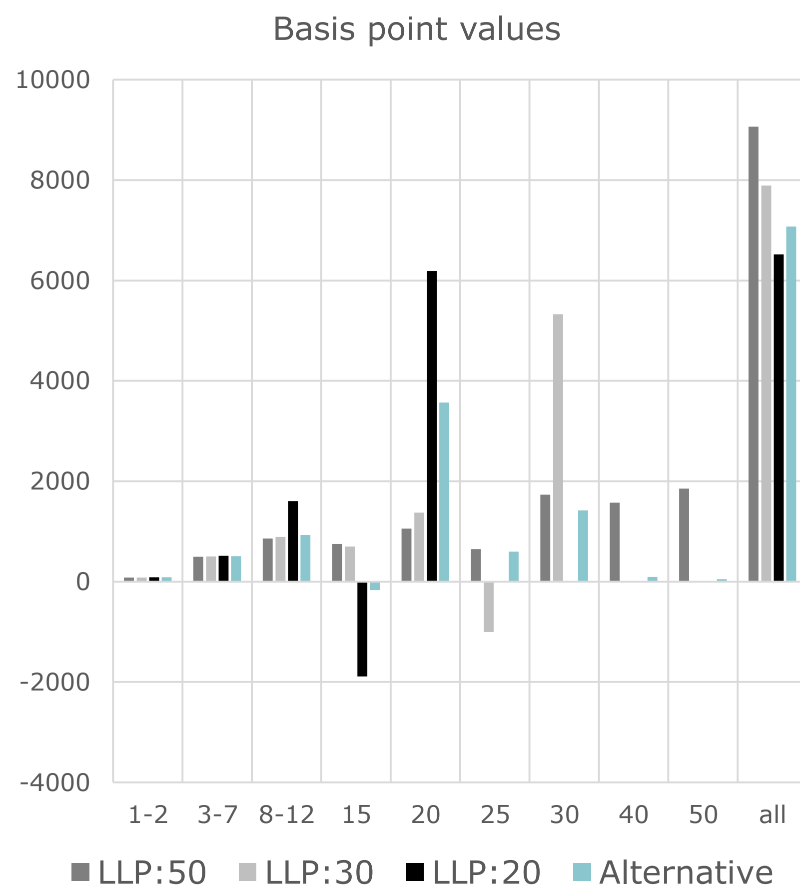




Extrapolation of risk-free interest rates

Interest rate sensitivities =>

- Smith-Wilson extrapolation puts relatively large weights on LLP and big negative weight on last rate before LLP.
  - Changes in delta 15-20 rates have relatively big impact on own funds.
- Alternative method has more moderate sensitivities.



Alternative extrapolation method

- Extrapolation to level of UFR according to current method.
- Convergence parameter at 10%.
- Extrapolation from Last Liquid Forward Rate at FSP/LLP to UFR
  - weighted with DLTness of rates

fw(15,20)	fw(20,25)	fw(20,30)	fw(20,40)	fw(20,50)
31.2%	13.9%	47.6%	4.7%	2.6%

Volatility adjustment

Workshop on 2020 review
Frankfurt, 6 December 2019

Volatility adjustment

Main objectives that can be attributed to the VA

1. Prevent pro-cyclical investment behaviour
2. Mitigate the impact of exaggerations of bond spreads on own funds
3. Recognise illiquidity characteristics of liabilities in the valuation of technical provisions

Volatility adjustment

Approach 1

Overshooting-Factor

Illiquidity-Factor

Improved risk correction

Permanent VA

$$VA^{perm} = GAR \cdot \min(AR_4; AR_5) \cdot RC\_S$$

Country-Spread

Average Country spread

Corridor

Macro VA

$$VA^{macro} = GAR \cdot \max\left(S_{jur} - \overline{S_{jur}}^{60} - corridor; 0\right)$$

$$VA = \max(VA^{perm}; VA^{macro})$$

GAR = General Application Ratio

Volatility adjustment

Approach 2

Overshooting-Factor

Illiquidity-Factor

Improved risk correction

$$VA = GAR \cdot \min(AR_4; AR_5) \cdot RC\_S$$

General application ratio

Undertaking-specific Fixed-income asset allocation

Volatility adjustment

Information request & consultation

- Choice between the two approaches
- Functioning of Macro-VA under approach 1
- Feasibility and reliability of calculations
- Stability of parameters
- Scope for simplifications
- Impact under different economic environments
- Assessment of direct DVA approaches in internal models under the two VA approaches (functioning & (dis)incentives)

Risk Margin

Workshop on 2020 review
Frankfurt, 6 December 2019

Risk Margin

Issues addressed in the Public Consultation:

I – Design of the risk margin and transfer value concept

II – Assumptions underlying the risk margin

III – Use of a fixed CoC rate

IV – Assumptions used to derive the CoC rate

Issue I

- EIOPA compared the value of the RM with data from actual portfolio transfers
- Scarcity of data limits the analysis
- However no evidence was found of systematic over or under calibration of the risk margin

Risk Margin

Issue II

- EIOPA assessed the validity of the assumption setting that the reference undertaking does not use the MA or the VA
- Several approaches are explored but after considering the pros and cons it is suggested to keep the current methodology unchanged

Issue III

- EIOPA analyzed the sensitivity of the risk margin to interest rate changes, as well as the dependency of the CoC rate to the level of interest rates
- There was mixed evidence which did not provide clear support for changes to the current approach

Risk Margin

Issue IV

- A thorough review of the CoC rate derivation was carried out in 2017 and 2018 as part of the Second set of Advice to the EC on specific items of the Solvency II Delegated Regulation
- No additional analysis was carried out as EIOPA had no new evidence that the previous conclusions were not valid anymore

Overall, EIOPA advice in the Public Consultation is that **no changes are introduced in the calculation of the Risk Margin**.

Questions to stakeholders are included requesting feedback on the analysis presented and the identification of other potential approaches not addressed so far.

EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

Equity risk

Workshop on the 2020 review of Solvency II
Frankfurt am Main, 6 December 2019

Draft Advice on equity risk (1/3)

- Standard equity type 1 and type 2
  - EIOPA advice is unchanged

- Duration based equity risk (DBER)
  - Adequacy of keeping two separate treatments (DBER and LTE) to address the risks of equity over longer time horizon is considered unnecessary.
  - DBER should be phased out. As such new approvals to use DBER should not be granted anymore.

Draft Advice on equity risk (2/3)

- Strategic equity investments
    - o Unclear elements of the framework
        - Lower volatility
        - Minimum ownership and control threshold of 20 percent in related undertakings
        - Correlation of risks
    - o No advice, only clarifications

- Infrastructure investments
- Unlisted equity
    - o No change to the precedent advices

Draft Advice on equity risk (3/3)

- Long-term equity investment (LTE)
  - EIOPA analysis based on historical series does not corroborate the 22percent capital charge
  - Diversified LTE portfolio

    → EIOPA advises an addition to Article 171a(1) so that LTE applies only to diversified LTE portfolio
  - Controlled intragroup undertakings

    → EIOPA advises an addition to Article 171a(1) to exclude controlled intragroup investments from the scope
  - Diversification between LTE and other risks:

    → LTE is currently included within other type 1 and type 2 short term equity risks and benefits from the same diversification

    → Draft opinion includes a first empirical analysis on correlation coefficient

Questions to stakeholders

- **Q2.10:** Should the correlation of risks between the participation and the participating undertaking be taken into account in determining whether a participation can benefit from the lower capital charge for strategic equity investment? Please explain your view.

- **Q2.11:** Considering the diversification of long-term equity risk with other risks: Do you have evidence to support any of the options set out in this section? If the answer is “Yes”, please elaborate on it.

- **Q2.12:** Do you consider that the illiquidity of liabilities (and more broadly the characteristics of insurance business) are reflected in an appropriate manner in the current equity risk sub-module? If the answer is “No”, please elaborate on the changes that you deem necessary.

Property risk

Workshop on 2020 review
Frankfurt, 6 December 2019

Property risk

- Current regulation sets a uniform shock of 25% for real estate risk across the EU, in the standard formula

- Current calibration was constrained by data availability of real estate annual returns with sufficient depth and frequency (from European countries with significant exposures only UK data was available in sufficient granularity)

- As, among the countries with significant exposures to real estate risk, the UK is also deemed to be one of the most volatile markets in Europe, this has been a source of criticism for the current approach

Property risk

- In recent years additional data sources became available, opening the possibility to revisit this issue
- EIOPA has assessed information from both Valuation based and Transaction linked indices, identifying the pros and cons of each approach
- Policy options (after considering data limitations):
  - No change
  - Single shock using all available data (average weighted by the exposure in each country)
  - Two shocks differentiating groups of countries with fundamentally different real estate markets

Property risk

- Data sources used are MSCI and ECB data
- Calibration based on 0.5% most negative annual return hard to achieve due to limited number of data points.
- To circumvent this limitation the method used was the minimum annual return from the sample taking all combinations of data points which are 12 months distant of each other.
- Results obtained exhibit significant differences from using VBI or TLI data. However EIOPA was not able to provide a definitive advice in time for the Public Consultation.

EUROPEAN INSURANCE
AND OCCUPATIONAL PENSIONS AUTHORITY

Interest Rate Risk

Workshop on 2020 review
Frankfurt, 6 December 2019

EIOPA's draft Advice in the CD

<u>EIOPA confirms the Advice issued during the review of the Delegated regulation (Feb 2018):</u>

Modelling interest rate risk in the standard formula with a relative shift approach, parameters of which vary in function of the maturity:

$$r_t^{up}(m) = r_t(m) * (1 + s_m^{up}(\theta_m)) + b_m^{up}(m)$$
$$r_t^{down}(m) = r_t(m) * (1 - s_m^{down}(\theta_m)) - b_m^{down}(m)$$

<u>Need for change</u> the current approach for calculating SCR_{IRR}:

- leads to a severe under-estimation of the risks: (the reality of IRs movements much stronger than those provided by the stresses in the DR);
- the current approach does not stress negative rates, although reality has proven that rates can continue to decrease;
- Significant deviations from IMs users methodologies;

<u>PROS</u> of the proposed approach: (i) simple and transparent; (ii) purely data-driven; (iii) risk-sensitive and applicable to any yield environment, (iv) it can well cope with low and negative interest rates.

Overall, the proposed interest rate shocks show a satisfactory performance in the backtesting for most EEA currencies and maturities

Updates & evolutions since 2018

Updates since the *Second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation*

- Two additional years of data (2017 and 2018) added to the time series (before was 1999-2016) → on average, a relative change of 1% in the shock components up to the EUR LLP (20 years) was observed: difference deemed negligible, thus <u>EIOPA supports the results of the previous calibration proposal</u>

- Analysis of potential interactions with parameters of the RFR term structure (focus on LLP):
  - Calibration for the extended LLP 30 and 50 years was carried out;
  - Alternative extrapolation method (AEM)
    - proposed calibration for the Smith-Wilson method with LLP of 20 years and the AEM with *First Smooting Point* (FSP) of 20 years coincide;
    - theoretically differences could arise from interpolated rates before the LLP/FSP, in practice interpolation yield with the two method are very similar: average differences of about 0.2bps → no recalibration for the AEM was carried out.

- <u>Gradual implementation:</u> EIOPA is assessing possible phasing-in → in the SCR review (DR) three-year period was proposed.

Recognition of non-proportional reinsurance in the Standard formula

Workshop on 2020 review
Frankfurt, 6 December 2019

Recognition non-proportional reinsurance

- ‘Non-proportional reinsurance is only partly recognized’
  - **However:**
  - Volume measure is ‘net of reinsurance’
  - Adjustment factor (80%) in the calculation of the premium risk (only for Property, MTPL and GTPL)

- Several EIOPA papers have addressed the issue
  - 2017/2018 review, also covering Adverse Development Covers (ADC)
  - 2020 review:
    - Questions on the topic in the 2020 review paper

Recognition non-proportional reinsurance

Questions to stakeholders

Q5.4: What is your view on the recognition of non-proportional reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals. How does the proposal address the double counting issue regarding non-proportional reinsurance covers between the CAT risk sub-module and other sub-modules impacted by treaties?

Q5.5: What is your view on the recognition of adverse development covers in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

Q5.6: What is your view on the recognition of finite reinsurance in the SCR standard formula? If you consider changes necessary, please make concrete proposals.

Recognition non-proportional reinsurance

- Challenges in finding solutions
  - To properly reflect non-proportional reinsurance in the standard formula one needs to make it more risk sensitive
  - Scenario based / Insurers specific
    - What is the retention of the XL-reinsurance?
    - How do we avoid double counting with Cat-risk?
- But:
  - We might need to introduce ‘more scenarios’ in the Standard formula.
    - Except from Cat-risk module
    - More difficult for insurers to calculate and to justify
    - Harder for supervisors to evaluate, they might ask for more data / evidence

Recognition non-proportional reinsurance

- Possible options
  - Create adjustment factors for all lines of business
    - What will be the impact?
    - Only on Premium Risk or also on Reserve risk?
    - How to calibrate the factors?
    - Only if there is reinsurance in place?
      - Currently the adjustment factor always applies to all LoB (indifferent if there is reinsurance in place)
  - A risk sensitive approach
    - What will be the impact?
    - How to justify the numbers used?
    - Administrative burden for Insurers

Recognition non-proportional reinsurance

- Envisaged next steps
  - Stakeholder input
  - Assessment considering
    - SF-principle
    - Risk sensitivity
    - Complexity
    - Prudency
  - Selection of options
  - Data analysis
  - Final decision

Federation of European Risk Management Associations

FERMA position on proportionality in Solvency II

29 November 2019

Introduction

The present document gathers the comments and recommendations of FERMA, bringing together 21 national risk management associations in 20 European countries. They represent nearly 5.000 risk and insurance managers throughout Europe, of which 37% are European captive insurance users.

FERMA believes that an efficient and harmonised application of the Principle of Proportionality (PoP) to small and less complex (re)insurance undertakings throughout European Member States is the cornerstone for an optimum and fit-for-purpose supervision. It will support both the industry's and the regulatory objectives.

FERMA considers there would be a significant value in reviewing how the Principle of Proportionality (PoP) is currently interpreted in the various Member States and in promoting a consistent approach to its application.

We believe the core principles of the PoP should be understood in a way that avoids discrepancies between Member States jurisdictions and differentiated from approaches that rely on thresholds and consequential exemptions.

We propose a conceptual approach to analyse the overall risk profile of any (re)insurance undertaking to ensure that proportionality is applied by EU national insurance supervisors using a harmonised methodology.

FERMA's proposal is aimed at supporting EIOPA and national competent authorities in determining which criteria and elements should be taken into account for assessing how any (re)insurance undertaking can benefit from the PoP and to what extent.

For a better application of the Principle of Proportionality, FERMA's main objectives are to:

- Promote an appropriate application of the PoP to small and less complex entities, notably the captive (re)insurance undertakings to ensure efficiency in EU companies' risk management and financing strategy.
- Promote better consistency in the way the PoP is applied throughout EU jurisdictions without losing the local flexibility allowed by the PoP.

EU Transparency Register ID No. 018778010447-60

- Simplify without compromising: while the PoP allows simpler or more flexible rules, these should not be less stringent. FERMA's view is not that regulatory requirements should be reduced or relaxed. Rather, we suggest improvements to achieve better proportionality, more efficiency in the way risks are mitigated and more meaningful reporting. More proportionality should not jeopardise regulatory objectives and core principles.
- Encourage practicality and proportionality for small and less complex (re)insurance undertakings in order to promote a more dynamic global insurance market with more diversity, competition and innovation to the benefit of customers.
- Privilege substance over form by focusing regulatory actions where they are delivering the intended results and avoid « tick-the-box » regulatory exercises, which are detrimental to both the industry (workload and costs) and the regulation's objectives.
- Focus on reporting, clearly allowing for the possibility of exemptions from quarterly reporting and simplify reporting processes for small and less complex (re)insurance companies.

1- FERMA's comments and opinion about the PoP

The underlying features of the PoP are as follows:

- Regulatory requirements must be applied according to the nature, scale and complexity of the regulated company.
- Regulatory actions and requirements should be commensurate with their final objective.

As a preliminary comment, FERMA would like to emphasise that the PoP is intrinsically a balancing act between the cost or burden of an action to achieve the regulatory objective and the ultimate purpose of the objective. The definition of the objective must be clear, unambiguously understood and the judgment needed to allow for proportionality to the outcome of the required action must be principally based on the level of completion of the initial objective.

As proportionality is a principle and not a rule, judgment is necessary in its application. The judgment must be structured and harmonised to ensure that it takes into account all elements of the equation (criteria, required action and objective) and avoid pitfalls such as:

- Overweighting the "size" criteria.
- Requiring a disproportionate outcome by misinterpreting the ultimate purpose of the objective.
- Focusing proportionality mainly on the cost or burden of the required action (i.e. allowing to do less) without questioning the rationale of the outcome itself (i.e. is the outcome required to meet the objective?).
- Treating proportionality criteria (nature, scale and complexity) separately without addressing their intrinsic connections and overall relationship through the lens of the ultimate objective.

FERMA believes that the way proportionality judgements are completed by national authorities misses such a harmonised and holistic approach.

In an internal survey conducted in 2018 to collect the views of local risk management associations and risk practitioners about the status of the application of the proportionality principle by supervisors since the enforcement of Solvency II, FERMA received the following comments:

- PoP application is not consistent across countries.
- Member States do not address reporting and governance consistently.
- PoP is either not applied or applied only in a very limited way for technical/actuarial and capital requirements.
- Some reporting proportionality is allowed in some Member States, but according to variable criteria.
- Some Member States have a kind of classification of insurers based on size and complexity, allowing for a slightly differentiated regulatory approach.

FERMA believes there would be a significant value in reviewing how the PoP is actually interpreted in the various Member States and in promoting a consistent approach to ensure judgment from national competent authorities allows proportionality to be harmonised.

As such, FERMA welcomes the proposal from EIOPA to complement and strengthen Article 35 by introducing:

- Alternative proportionality instruments.
- Risk-based methodologies not directly dependent on the decision/culture of the respective national authority.

Beyond concrete and practical simplifications proposed by EIOPA, FERMA strongly believes that the overall objective of reviewing the efficiency of the PoP should not only focus on adjusting the current practices. It should also and mainly focus on developing a holistic risk-based approach that allows consistency throughout European Member States.

We previously mentioned the importance of the definition (or understanding) of the final objective of regulatory measures. Within this context, FERMA believes the risk-based approach proposed by EIOPA is the way to efficiently address the PoP. Regulatory attention should focus on those areas where the activity or overall risk profile of a (re)insurance undertaking threatens the ultimate objective of the regulation.

2- FERMA's suggested approach to a consistent PoP methodology

Based on the above, FERMA is pleased to suggest a conceptual approach aimed at supporting EIOPA's further work in achieving a more harmonised risk-based methodology in applying the PoP.

The approach described below is consistent with the nature of FERMA, which is to promote professional risk management practice. We believe that professional risk management practice is well suited for supervisors to perform their role as regard the risk assessment of insurance undertakings for proportionality purposes.

The approach is also consistent with the risk-based nature of Solvency II, and FERMA believes it could accommodate all national authorities in allowing them to assess the basis for proportionality while not jeopardising flexibility.

FERMA also believes such a harmonised approach will bring some relief in the supervisory workload of the national authorities allowing them to focus their efforts on the core supervision tasks to ensure the highest level of financial stability, consumer protection and market discipline.

Finally, FERMA also wants to highlight that the suggested approach is a conceptual but hopefully sufficiently detailed attempt to support EIOPA and national authorities in defining a risk-based proportionality methodology. It should be seen as a contribution to the debate and not as a comprehensive or prescriptive proposal.

Underlying Principles

- The objective of the FERMA approach is to ensure that proportionality is evaluated consistently by EU national supervisors, while keeping a flexibility in the intensity of the proportionality measures.
- Proportionality criteria (nature, scale and complexity) should not be regarded as separate but assessed together, i.e. as defining a (re)insurance undertaking's overall risk profile.
- The ultimate objectives of Solvency II (financial stability, consumer protection and market discipline) are intrinsically part of the overall risk profile assessment.
- The link between proportionality criteria and ultimate objectives of the regulation should be assessed in a single step, allowing for the risk profile and the related proportionality decision to be addressed holistically.

Considering that proportionality is lost if it is defined, FERMA's approach focuses on the methodological way to assess how and to what extent proportionality should be applied to any (re)insurance undertaking according to its overall risk profile.

Our proposed approach is innovative since it considers the objectives of Solvency II (financial stability, market discipline and policyholder protection) as a starting point. It does not focus only on the specific

EU Transparency Register ID No. 018778010447-60

risks within the undertaking but links the business model and related risk profile of an insurance undertaking with the policy objectives of Solvency II.

Our Starting Point: How to Answer the Three Fundamental Questions

FERMA's methodology has been structured as a potential answer to the following three questions:

1) How can we link proportionality criteria (size, scale and complexity) into one single risk profile for any (re)insurance undertaking?
2) How can we link the risk profile to the ultimate objectives of the regulation (policyholder protection, financial stability and market discipline)?
3) How can we link that final result to concrete proportionality measures?

A four steps approach

- **STEP 1: Overall Risk Profile Matrix**

The first step is to build a matrix combining the proportionality criteria and the regulation objectives as follows:

		Potential Impact on Regulation Objectives		
		Policyholder protection	**Systemic risk mitigation**	**Market discipline**
Proportionality Criteria	**Nature**	Level 1	Level 1	Level 1
		Level 2	Level 2	Level 2
		Level 3	Level 3	Level 3
	Scale	Level 1	Level 1	Level 1
		Level 2	Level 2	Level 2
		Level 3	Level 3	Level 3
	Complexity	Level 1	Level 1	Level 1
		Level 2	Level 2	Level 2
		Level 3	Level 3	Level 3

Figure 1 Matrix combining the proportionality criteria and the supervision objectives of the Solvency II Directive

- Each of the above levels is a scoring from the lowest (1) to the highest (3) which will be attributed to the (re)insurance undertaking based on a predefined assessment rule. We provide in Appendix 1 some examples of these assessment rules which aim at positioning the (re)insurance undertaking level of exposure considering a given proportionality criteria on one hand and a given regulation objective on the other hand.

- Once the entire assessment is completed, the (re)insurance undertaking obtains a rating for all of the matrix intersection as well as an overall rating for all 3 proportionality criteria and all 3 regulation objectives.

- This overall regulatory risk profile is then represented in a radar chart which gives an overview of the (re)insurance undertaking strengths and weaknesses in terms of proportionality applicability. See the below illustration.

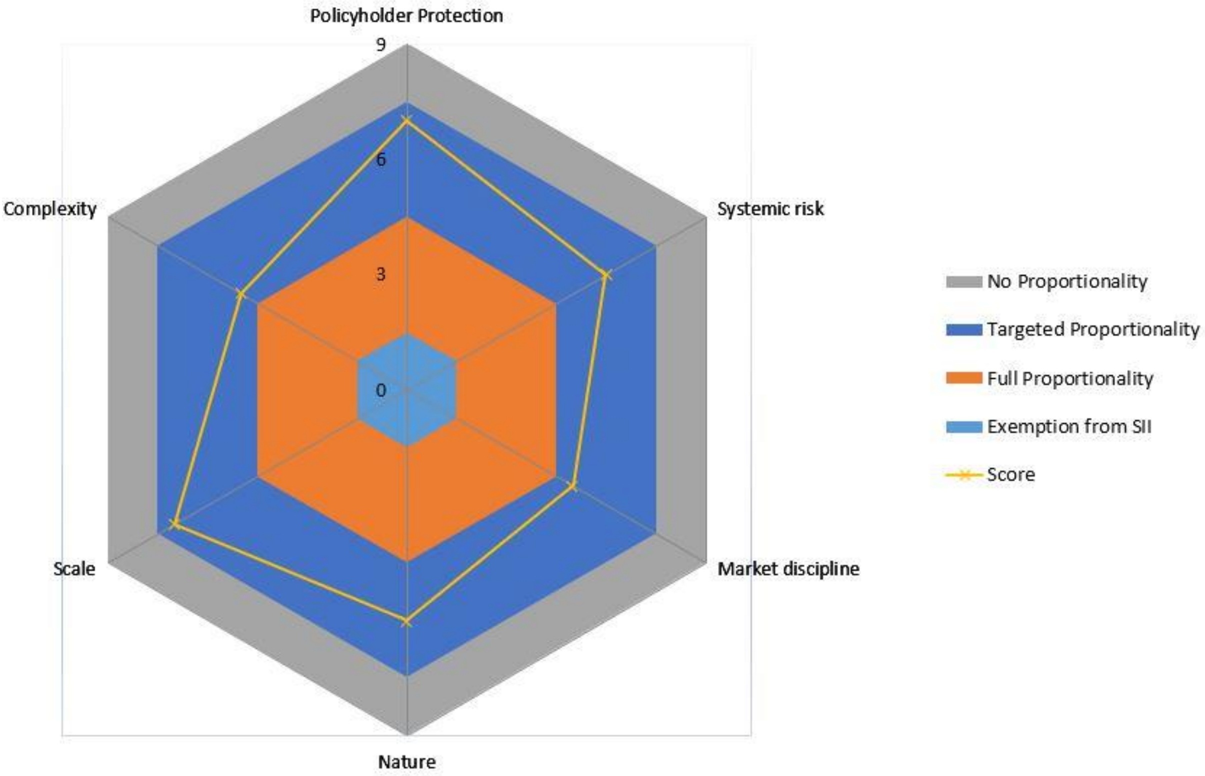


Figure 2 Possible radar representing the overall regulatory risk profile of an insurance undertaking

- **STEP 2: Four Levels of Applicable Proportionality**

In order to enable a more harmonised risk-based methodology for proportionality, a set of differentiated levels of proportionality would be defined, for instance as follows:

- Level 1 (lowest scores): Full Solvency II exemption

- Level 2 (medium-low scores): Full Proportionality
- Level 3 (medium-high scores): Targeted Proportionality
- Level 4 (high scores): No Proportionality

While Levels 1 and 4 would be obvious as their rationale and their scope are reduced to what is strictly necessary, the full essence of the PoP and its benefits could be optimally deployed within Levels 2 and 3.

- **STEP 3: List of Applicable Proportionality Measures**

Deploying the PoP more efficiently within Levels 2 and 3 would require the Supervisory Authorities to complete a review of existing as well as potential proportionality measures that could be applied to (re)insurance undertakings meeting those proportionality risk profiles.

Understanding what proportionality measures could be applied for specific overall risk profile would be the concrete bridge between the objectives of Solvency II and the actual business model and risk profile of (re)insurance undertakings.

The methodology will be efficient only if it leads to proportionality measures that are concrete and operational.

- **STEP 4: Linking Risk Profile and Concrete Proportionality Measures**

In order to be efficient, the Targeted Proportionality (Level 3) would then connect the various proportionality measures to the risk profile assessed through the proportionality matrix described here above (step 1). By defining for instance, a maximum rating for each of the 6 criteria/objectives above which the proportionality measure cannot be granted, the methodology would allow for more predictability, harmonisation and consistency across the Member States.

CONCLUSION

FERMA has developed a proof of concept encompassing a complete set of tools, list of proportionality measures, rationale for the matrix as well as proportionality criteria and regulation objectives. Assessed altogether, these elements, supported by operational examples, could indicate how and to what extent proportionality measures can be applied.

The full methodology that we are introducing in this document will be submitted to EIOPA in January 2020, following the 2nd wave of consultation on the Opinion on the 2020 review of Solvency II.

FERMA would welcome the opportunity to cooperate further with EIOPA and the National Competent Authorities (NCA) to investigate the practicality of our proposal to improve and strengthen the way proportionality is applied within the (re)insurance industry.

It would represent a real progress for the Solvency II framework and would ensure that the proportionality principle fully benefits to all stakeholders, both supervisors, (re)insurance undertakings and end consumers.

Appendix 1 – Examples of business model description for assessing the risk profile

Example 1 - "Nature Vs. Policyholder Protection"

LEVEL 1
The (re)insurance undertaking products are very specific and/or addressed to a very limited number of professional clients (e.g. captive industrial/commercial risks, nuclear risks, aerospace risks, ...)

LEVEL 2
The (re)insurance undertaking products are common but addressed only to professional/institutional clients (e.g. industrial/commercial risks, credit risks, cyber risks, …)

LEVEL 3
The (re)insurance undertaking products are addressed to the wider consumer market (e.g. motor, household, life, mortgage, warranty extension, rental insurance, ...)

Example 2 - "Scale Vs. Market Discipline"

LEVEL 1
The (re)insurance undertaking has an insignificant share in the local market

LEVEL 2
The (re)insurance undertaking does not have a big share in the market but is part of the top 80% of the local market in terms of gross written premiums

LEVEL 3
The (re)insurance undertaking is locally amongst the top 10 market leaders with a sizeable market share

Appendix 2 – List of Potential Applicable Proportionality Measures for Reporting (Pillar III) – Not Comprehensive

			Applicability (applicable if score <= x)						
S2 Pillar	**Building Block**	**Proportionality measure**	**Policyholder protection**	**Systemic risk mitigation**	**Market discipline**	**Nature**	**Scale**	**Complexity**	**Already applied?**
P3 -Reporting	QRTs Frequency	Exemption to provide quarterly QRTs (annual instead), only quarterly monitoring of MCR by Actuarial Function	6	4	3	4	4	4	Luxembourg, Netherlands, France
	QRTs Technical Provisions	Reduced scope of the annual reporting with exemption from currency breakdown	6	6	4	6	4	6	
	QRTs Premiums&Claims	Reduced scope of the annual reporting with exemption from geographical and currency breakdown							
	QRTs Investments	Reduced scope of the annual reporting with exemption from look through reporting							
	QRTs SCR & MCR	Reduced scope of the annual SCR reporting with exemption from sub-module details							
	RSR	RSR to be provided to the Regulator only every three years, unless pre-determined events occur							Luxembourg, France
	ORSA Report	No obligation to disclose the ORSA report to the regulator, but it should be made available on request							Ireland, Switzerland
	External Audit of S2 reporting	No external audit of Solvency II regulatory returns							
	QRTs Investments	Exemption to include external ratings in SII annual and quarterly reporting to avoid additional costs							Luxembourg
	SFCR	Waiver from public disclosure within the SFCR of items which are potentially sensitive information							
	SFCR	Reduced scope of the SFCR to brief description of the undertaking, key financial figures and SCR ratio							
	SFCR	Exemption from SFCR							

EU Transparency Register ID No. 018778010447-60

Contact person: Julien Bedhouche, FERMA EU Affairs Adviser, julien.bedhouche@ferma.eu

FERMA - The Federation of European Risk Management Associations brings together 21 national risk management associations in 20 European countries. FERMA represents the interests of more than 4800 risk and insurance managers in Europe active in a wide range of business sectors from major industrial and commercial companies to financial institutions and local government bodies. More information can be found at www.ferma.eu

EU Transparency Register ID No. 018778010447-60

Principle of Proportionality in Solvency II

Workshop on 2020 review
Frankfurt, 6 December 2019

Preliminary remark

- Proportionality is an important principle in the EU and in Solvency II;
- Under Solvency II proportionality should be applied both at the level of regulation (e.g. simplification) and on the level of Supervision (see also SRP GL 3*);
- Under Supervisory Convergence work EIOPA has approached the issue of proportionality principle a number of times, for instance:
  - Peer review on the principle of proportionality when assessing key functions (Nov 2018);
  - Supervisory statement on application of the proportionality principle in the supervision of the SCR (March 2019);
  - Peer review on supervisory practices and outcomes on the use of proportionality regarding the RSR (on going).

* "the national supervisory authority should ensure that the principle of proportionality is observed throughout all the stages of the supervisory review process"

2020 review: proportionality for pillar I

- Review of Delegated Regulation in 2018 covered proportionality in particular on simplified calculation of the SCR standard formula, look-through approach, non-life CAT risk and counterparty default risk;

- Current Consultation Paper includes proposals for additional simplification to the SCR standard formula with regard to immaterial risks;

- Stakeholders are invited to point out areas where proportionality in Pillar 1 can be further improved.

2020 review: proportionality for pillar II issues

- **Key Functions**: the draft advice proposed, under certain conditions, combination with operational functions (no IA), AMSB member or other KF;
- **ORSA**:
  - biannual assessment of the deviation of insurers’ risk profile;
  - proportionality regarding complexity of stress tests/scenario analysis;
- **Written policies**: the regular review possible up to 3 years;
- **AMSB**: reinforcing the regular assessment of insurers’ system of governance, taking into account proportionality;
- **Remuneration**: limitation of the mandatory deferral of a substantial portion of variable remuneration component;
- Finally, specific simplification for **captives’** ORSA are being considered .

2020 review: proportionality in reporting

- Keep Art. 35 of SII Directive (NCAs may exempt up until 20% of the market share as today);
- Improve the use of risk-based thresholds in non-core templates;
- Further simplification of quarterly QRT: deletion of Derivatives transaction template and simplification of Open Derivatives and Technical Provisions templates;
- Simplification of other QRT:
  - Deletion of off-BS list, Summary Assets, Derivatives transaction, Variable annuities, 2 out of 4 Variation Analysis
  - Simplification of assets and liabilities by currency, derivatives, reinsurance

Proportionality in SRP

- Proportionality is clearer when it is more rules-based (e.g. simplifications or reporting thresholds) but requires supervisory judgment when it is more principles-based (e.g. pillar II or exemptions from quarterly reporting);
- As currently being consulted additional measures could be reflected in the legal framework;
- Proportionality applied at the level of supervision (SRP) could also be improved, for instance by clarifying:
  - the legal aspects of its applicability;
  - the need to consider equally costs & benefits of proportionality;
- However, a risk-based approach needs to be ensured and national specificities together with culture and historical practices, play an important role.

Proportionality – Way forward

- EIOPA is promoting a convergent use of proportionality in the SRP in several ways (e.g. recommendations from Peer Reviews, Guidelines & Supervisory Statement, Handbook, share of experience in training…);
- EIOPA is analysing stakeholders proposals and considering how to improve the implementation of proportionality in the Supervisory Review Process.