Memo for information

To: Solvency II WG
From: Prudential Team
Date: 15-11-2023
Reference: ECO-SLV-23-211

Subject: Summary of EC non papers released in the context of SII trilogues

Summary

On 14 November, the secretariat circulated a number of non-papers prepared by EC in the context of the SII 2020 review trilogues.

- ECO-SLV-23-206 – Non-paper on LTG measures
- ECO-SLV-23-207 - Non-paper on sustainability
- ECO-SLV-23-209 - Non-Paper on proportionality
- ECO-SLV-23-208 – Non-Paper on reporting
- ECO-SLV-23-210 - Non-paper - cross border activities

The secretariat prepared a summary of the main elements included in the non-papers.

Should members have any comments, please write to prudential@insuranceeurope.eu.

Key points of Commission service's non-papers

1. **Non-paper on Long-Term Guarantee measures and long-term equity** (ECO-SLV-23-206)

Risk margin

- **Lambda:**
  - EC suggests incorporating a qualitative provision in Level 1, similar to the one suggested by the Parliament.
- **Cost of Capital:**
  - EC notes that, in the current interest rate environment, a significant decrease in the CoC rate is not technically justified based on economic evidence and suggests that maintaining it in Level 2 could allow for more regular reviews of its values.
  - In particular, the following ways forward are suggested:
    - Maintain the CoC in Level 2 (Council's proposal).
    - Set the CoC in the Directive (Parliament's proposal).
    - Maintain the CoC in Level 2 with a mandate for the EC or EIOPA to regularly review its appropriateness.
    - Maintain the CoC in Level 2 and introduce a Level 1 provision that sets a quantitative framing of the CoC in Level 2 (e.g. a ceiling and/or a floor to an appropriate range of values).

Extrapolation

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- **First Smoothing Point (FSP) for the Euro:**
  - EC suggests that co-legislators shall consider whether:
    - Market conditions at the date of entry into force of the amending Directive shall be used as a benchmark for determining the FSP. EC notes that this would imply that co-legislators are anticipating that future market conditions would be similar to the current ones.
    - FSP for the Euro should be 20 years, equal to the current value of the last liquid point, irrespective of market conditions at the date of entry into force.

- **Weight to the UFR for the Euro:**
  - EC advocates for a lower convergence parameter, arguing that the current high interest rate environment provides a timely opportunity for implementation given that the limited impact would allow a smoother transition.
  - The following way forward is proposed:
    - If co-legislators wish to frame more strictly the EC's empowerment, they may consider setting a floor to the value of the weight to the UFR in Level 1 (e.g. 75%).

- **Transitional arrangements**
  - EC suggests that the mandatory phasing-in, which was initially proposed to ensure a smooth transition, might no longer be deemed relevant given the lower impact of the proposed changes attributed to the high interest rate environment.
  - In light of this, EC suggests that co-legislators shall consider whether:
    - The new interest rate environment still makes it necessary to introduce a phasing-in for extrapolation.
    - If a phasing-in is considered relevant, whether it should be mandatory or at Member States' discretion.

Volatility Adjustment

- **Risk Correction**
  - EC notes that EP proposal could reintroduce overshooting issues with insurers being "better off" in crisis times than in normal times, contradicting one of the main objectives of the review.
  - EC is of the view that it would be more appropriate to keep such framing in Level 2, which would better guarantee its harmonised application. EC suggests that co-legislators shall consider whether there should be:
    - No framing in Level 1, in line with Council's position, allowing the EC to proceed with Level 2 (Council's proposal).
    - A framing in Level 1, introducing a link to the fundamental spread (Parliament's proposal).
    - Some guiding principles in Level 1 that would ensure that future Level 2 amendments would reduce the likelihood of overshooting, while having a lower quantitative impact than that implied in EIOPA's Opinion.
      - Specifically, a mandate to the EC could be considered to further develop differentiated treatment for cases where current spreads are lower than LTAS, cases where current spreads are higher than LTAS but lower than twice such averages and cases where current spreads are higher than twice LTAS.

- **Optional overshooting ratio**
  - The EC notes that a cap above 100% would not be consistent with the ratio's objective to address overshooting and could also threaten the level-playing field as it could artificially improve the solvency position of insurers that choose to use it.
  - Considering co-legislators aligned position for the introduction of an overshooting ratio in Level 1, the following options are suggested:
    - Capped at 100%.

- Capped at 125%, where an adjustment higher than 100% would only be possible for up to 4 consecutive quarters.
- Could be allowed to reach values slightly above 100% but for a limited period (e.g. a quarter).

Long-Term Equity Investments (LTEI)

- Overall, the EC takes a critical stance towards the EP proposal. In particular, the EC makes the following remarks:
  - Insurers could potentially bypass the LTEI eligibility criteria by investing indirectly in equity through various types of collective investment undertakings. EC questions the prudential and technical justification of allowing such flexibility for every type of fund, unless the risk of funds would justify it.
  - EC notes that incorporating LTEI criteria in Level 1, with a possible complement of Level 2 provisions, would not be sufficient by itself to achieve an easier application of this sub-module, while doing so would pose some additional difficulties such as:
    - Qualitative criteria could be implemented differently across Member States leading to a potential undermining of the level playing field.
    - The regulatory landscape will become even more complex.
    - Increased compliance risk for insurers.
    - The overall design and logic of the framework would be distorted by migrating technical provisions from Level 2 to Level 1.
    - By incorporating the criteria in Level 1, it would be more difficult to amen them where and when needed.
- Considering the above, the EC is of the view that the LTEI criteria should remain in Level 2 due to their technical nature. However, if co-legislators decide to include them in Level 1, then the following should be considered:
  - The introduction in the Directive of a preferential treatment LTEI whose capital charge would have to be calibrated over a multi-year time horizon.
  - An empowerment for an EC Delegated Act that would frame the prudential treatment of LTEI and would constrain EC on the possible list of eligible criteria.
    - The Directive shall empower the EC to define rules and criteria for LTEI focused on the methods, assumptions and standards parameters related, as well as the topics to which eligibility criteria should be tied (e.g. geographical scope of eligible investments, avoidance of forced selling of LTEI portfolio etc)
  - A framework for cases of non-compliance with the criteria.
    - The Directive could provide details in case of non-compliance with all or some of the LTEI criteria. As regards Level 2, the EC could be mandated to specify risk factors to be applicable in case of temporary non-compliance with a criterion.
  - Clarifications on the applicable rules at group level.
    - Equity investments classified as LTEI at a solo level should automatically qualify at group level as well, unless supervisory authority requires otherwise for certain circumstances related to the undertaking's liquidity risk or significant intragroup transactions or risk concentrations.

2. **Non-paper on Sustainability** (ECO-SLV-23-207)

- **Definitions:** the concepts such as 'ESG risks' and 'ESG factors' are proposed by EP but are not currently defined in SII. EC suggests to not introduce them to avoid confusion.
- **EC notes that Sustainability risks already have to be reflected in the system of governance, risk management system and their supervision**.

- Since August 2022, insurers are required to integrate sustainability risks at least in their underwriting/reserving /asset-liability management/ investment risk management policy and, where relevant, in the rest of the mandatory policies listed in DR Article 260(1) .
- Co-legislators could consider introducing a provision in Article 44 'Risk management system' that reflects the various time horizons over which sustainability risks should be assessed on the basis of the EP text. This would be in line with the proposal made in the CRD 6 to consider the management of ESG risks from a short-, medium- and long-term perspective. Co-legislators could also consider making more explicit the role of supervisors in relation to sustainability risks integrated in the risk management framework of insurers.
- When discussing amendments to the Directive regarding the potential broadening of the risk management areas, co-legislators should consider whether the references to sustainability risks in Article 260 'Risk management areas', Article 269 'Risk management function' and Article 275 'Remuneration policy' of the Delegated Regulation are already sufficient to allow the risk management system of insurers to appropriately consider these risks. If yes, it is important these are consistent with the already existing L2 rules.

- **Sustainability in the PPP**
  - When discussing amendments to the Directive regarding the potential inclusion of the inside-out perspective of the double materiality concept within the formulation of the prudent person principle, co-legislators should consider whether the current L2 rules sufficiently capture this requirement already.
  - If co-legislators conclude that this is not the case and therefore additional provisions should be added in L1, it is important that these do not result in duplication. Furthermore, consistency between amendments to Dir Article 132 and DR Article 275a should be sought, in order to reduce risks of incoherence between both pieces of legislation which may cause disruption and legal uncertainty for both the industry and supervisors.
- **Transition plan**
  - SII currently does not require insurers to draw up transition plans nor does it explicitly require insurers to do transition planning, however it legally requires insurers to manage all risks, including transition risks, in a forward-looking manner. (ORSA, in which insurers have to assess the effect of transition risks stemming in the short- and long-term from their overall solvency needs and adopt corresponding risk mitigation measures to manage their exposures (e.g., decrease investment to activities or companies susceptible to become stranded).
  - Clarification of EP transition plan proposals is requested on the following aspects:
    - whether the plans would build on other existing plans
    - the extent of the insurance supervisor's role and responsibilities in relation to these plans and transition targets.
    - Thirdly, irrespective of whether the plans under Solvency are the same or not as the plans under the CSRD (and possibly the future CSDDD), how will alignment or consistency among the plans be ensured.
  - Options on the table according to EC:
    - Option 1: Introduce requirements in the risk management system, and in particular, in the ORSA that build on the existing requirements on transitions plans (CSRD/CSDDD).
    - Option 2: Introduce in SII the obligation to develop a prudential plan:
      - Implies having two plans, for different objectives: corporate transition plans (CSRD/CSDDD) and prudential, risk-based transition plans under SII, as a risk management tool focused on the risks of misalignment to the net zero objective
      - A role for EIOPA could be considered to further elaborate the content/scope/supervisory expectations
- **Disclosures:**
  - In reaction to EP proposal to publicly disclose principal adverse impacts on sustainability factors, EC notes this is already requested in CSRD/SFDR. In addition, the EC notes that under the CSRD, most

insurers will have to disclose in their management report the resilience of their business model and strategy in relation to risks related to sustainability matters
    - Co-legislators should consider avoiding introducing in SII additional sustainability disclosure requirements that are regulated under horizontal and cross-sectoral pieces of sustainable finance legislation.
- In reaction to EP proposal to disclose climate change scenario analysis results and the prudential plans and targets, the EC notes the following:
    - This decision of disclosure should be carefully considered in relation to the risk management objectives that these analyses and plans pursue in the context of Solvency II. In this regard, if co-legislators are willing to introduce 'prudential' transition plans into the framework as done in the CRD 6, they should consider whether the benefits of disclosing these plans and targets (e.g., transparency and public accountability) would outweigh the potential risks associated with publicly disclosing them. The same would apply to the results of scenario analysis.
    - Both the disclosure of the results of these analyses and the content and targets of such plans in the SFCR could potentially undermine their value and purpose as risk management tools due to the potential reputational and legal risks associated with publicly disclosing them.

- **Proportionality**
    - When exempting LRPU from climate scenario analysis, co-legislators should consider all risks, including reputational risks. And co-legislators should consider imposing strong safeguards in order to avoid a fragmented approach on the management of climate risks and ensure a level playing field for insurers across the EU.

- **Amendments to accounting directive**
    - EC see it as a possibility to introduce the EP provision that allows undertakings qualifying for LRPU status under SII to be recognised as SME for the purpose of CSRD.

3. Non-paper on Proportionality (ECO-SLV-23-209)

- Paper contains legislative text drafting suggestions from the EC.
- No decision taken yet on naming, both LPRU and Small and non-complex undertaking are still on the table
- **Non-traditional investments criterion** is replaced with a criterion where the sum of the following is not higher than [15%-20%] of total investments:
    - 'gross market risk module'
    - 'the part of the counterparty default risk module that corresponds to exposures to securitisations, derivatives, receivables from intermediaries and other investment assets which are not covered in the spread risk sub-module'
    - 'any capital requirement that is applicable to investments in intangible assets that are not covered by the market risk and the counterparty default risk modules'.
- **Cross border criterion** includes both an absolute [15-30 Mio] and a relative threshold [5% of GWP]. (*This criterion change is also proposed for proportionality at group level*)
- **GWP related to Class 3 and 4 of section A of Annex I are excluded** from the requirements to have a total annual gross written premium of non-life business lower than 30%. On the other hand classes 5-7, 11, 12 are added. (*This criterion change is also proposed for proportionality at group level*)
- **Captive (re)insurers** are considered as LRPU if they comply with both of the following conditions:
    - all insured persons and beneficiaries are any of the following:
        - legal entities of the group of which the captive (re)insurance undertaking is part,

- natural persons eligible to be covered under that group's insurance policies, provided that the business covering those natural persons remains below 5% of technical provisions;
  - the insurance obligations/contracts underlying the reinsurance obligations of the captive (re)insurance undertaking do not consist of any compulsory third-party liability insurance.
- **The following undertakings cannot be classified as LRPU:**
  - (Partial)IM companies
  - Parent undertakings of a financial conglomerate
  - Undertakings that are parent undertakings of an undertaking referred to in Article 228(1) points (a) to (e)
  - Undertakings that manage group pension funds, where the value of the assets of the group pension funds exceeds 1 Billion.
- **Specification of the criteria:** EIOPA is no longer requested to prepare guidelines. The EC shall adopt DR to specify the criteria, the methodology to be used when classifying undertakings/groups as LRPU and the conditions to grant/withdraw NSA approval for proportionality measures used by non-LRPUs.
- **Monitoring of the use of proportionality measures**
  - Within 1 year from classification as LRPU,
  - Undertakings shall inform NSA directly when they want to change the list of the proportionality measures used or when they want to stop using a specific measure.
  - Undertakings can use the proportionality measures up to 4 financial years, without applying the requirements set out in Art 29b/c/d
- **Proportionality measures**
  - RSR every 3 years, or subject to NSA approval, every 5 years.
  - Written policies for LRPU at least every 5 years, unless NSA decides, based on the specific circumstances, that a more frequent review is needed, or where time horizon of the business plan of the undertaking is less than 5 years.
  - Simplified calculations for a specific submodule/risk module, when all conditions are met:
    - The nature/scale/complexity justifies the use of a simplified calculation
    - It would be disproportionate to require the insurer to apply the standardized calculation
    - The error introduced by using the simplified calculation does not lead to a material SCR misstatement, unless it is more prudent than the standard formula SCR.
    - An exception for complying with all abovementioned conditions is allowed when the undertaking can demonstrate that 'each individual submodule/risk module for which a simplified calculation is used represents – without using the simplification – less than [2%] of the Basic SCR' AND 'the sum of all submodules/risk modules for which a simplified calculation is used represents – without using the simplification – less than [10%] of the Basic SCR.
- **Proportionality measures at group level**
  - The following criterion is removed :
    - ii) the return on investments, excluding investments held for insurance obligations with index-linked and unit-linked benefits, is higher than the average guaranteed interest rates;
  - The following criteria are added:
    - (fa) the difference referred to in Article 230(1) where method 1 is used, in Article 233(1) where method 2 is used, or in Article 233a(1) where a combination of methods is used, is positive.
    - (g) where method 2 or a combination of methods 1 and 2 is used, each undertaking to which method 2 is applied is a [low risk profile/small and non-complex] undertaking.
  - The following groups shall never be classified as small and non-complex groups:
    - financial conglomerates
    - groups where at least one subsidiary undertaking is an undertaking referred to in Article 228(1);
    - groups which use an approved partial or full internal model to calculate their group SCR.

4. Non-paper on Reporting (ECO-SLV-23-208)

Standard formula reporting for internal model users

- A text proposal for Article 122 is included reflecting the discussions that took place during the political trilogue on 25 October.
  - An estimate of the SCR, determined in accordance with the standard formula, shall be provided every 2 years to the supervisory authorities.
  - More frequent reporting can be requested by NSA.
- As also requested, the Commission also included a recital (44) to clarify the meaning of "estimate of the Solvency Capital Requirement determined in accordance to the standard formula".
  - According to the draft recital, "*such an estimate should appropriately reflect the methods and underlying assumptions of the standard formula facilitating a proper supervisory assessment".*
  - Undertakings would be allowed to make use of SF simplifications, as specified in the Directive and its delegated acts, and the underlying assumptions should be clearly explained to the NSA.

Extension of reporting deadlines in exceptional circumstances

- The following possible ways forward are suggested per identified objective:
  - **Ensuring legal certainty:**
    - No change of regular deadlines but temporary deviation allowed under Level 1 and applied via implementing acts.
    - Extension period up to 10 weeks (Council's position).
  - **Swift reaction to market developments:**
    - Implementing act allows for an emergency adoption procedure.
    - Clear timelines for all parties involved.
  - **EIOPA role:**
    - EIOPA assessment of whether conditions for deadline extension are met.
    - EIOPA's assessment must be taken into account by the Commission and possibility for the Commission to request such assessment by EIOPA.
    - European wide communication.
  - **NSA role:**
    - NSAs can request EIOPA to assess whether conditions for deadline extension are met.
    - Support EIOPA assessment.
    - Communication to national markets.
- Drafting text suggestions are included reflecting the aforementioned points.

5. **Non-paper on Cross-Border supervision** (ECO-SLV-23-210)

- Paper contains some draft text, prepared by the EC, which could serve as a basis for finding compromises.

- **The definition of significant cross-border activities encompasses an absolute threshold, a relative threshold, and well-framed supervisory discretion [to be specified through guidelines/regulatory technical standards] with EIOPA's binding mediation in case of disagreement – new Article 152aa. Criteria are the following:**
  - Annual GWP > [15-30Mio]
  - Annual GWP in a host MS under FoS/FoE > [15%-20%] of annual GWP of undertaking, unless host NSA deems the FoS/FoE activities non relevant.
    - Host NSA deems the FoS/FoE activities relevant with respect to the host MS market, EIOPA shall issue guidelines to specify conditions/criteria to be used.
    - Host MS shall notify the home NSA of this and state the reasons. If home NSA disagrees, it shall notify the host NSA within 1 month and the matter may be referred to EIOPA in case of disagreement.
  - LRPU are excluded

- **Enhanced cooperation and information exchange framework is applicable for significant cross-border activities. – new Article 152ab**
  - in case of significant cross border activity home/host NSA shall cooperate to assess whether insurer has a clear understanding and a sound management of the faced risks in the host MS.
  - Cooperation shall be commensurate to the risks entailed by the significant cross border activity and cover at least:
    - System of governance, including the AMSB ability to understand cross border market specificities.
    - Outsourcing arrangements
    - Business strategy and claims handling
  - Home NSA shall inform host NSA of the outcome of the supervisory review process of the significant cross border activity where potential issues of compliance or material issues related to the aspects referred to in para 1. And when these activities will (likely) affect the exercise of activities in the host MS.

- **The identification of a significant cross-border insurer triggers automatic information exchange between supervisory authorities.** The minimum scope of that information sharing is clearly defined and avoids excessive administrative burden. Host supervisors may request additional information, where necessary. – new Article 152ab
  - Information to be shared at least annually
  - SCR, MCR, Eligible own funds covering SCR/MCR, assessment of home NSA of appropriateness of the insurance undertaking's calculations of the technical provisions.
  - Home NSA shall inform host NSA immediately without delay where it identifies deteriorating financial conditions or a risk of non-compliance with the SCR/MCR within the next three months.
  - Host NSA may ask, when duly justified, the Home NSA for information regarding that it is related to the solvency, the system of governance or the business model of the insurance undertaking.
  - When the information is not provided in a timely matter the host NSA may refer the matter to EIOPA

- **In relation to significant cross-border insurers, host authorities could request a joint on-site inspection in case of breach of capital requirements.** While the home supervisor would have the possibility to reject the request, any authority could then solicit EIOPA's binding mediation. – new Article 152ab

- If the home MS accepts a joint onsite inspection, it shall invite EIOPA.
- Joint conclusions shall be reached within 2 months after the inspection, incl on the most appropriate supervisory actions. In case of disagreement on conclusions, home/host NSA may refer the matter to EIOPA. And the conclusions in conformity with EIOPA's decision shall be adopted.

- **The current rules regarding the setting-up of collaboration platforms are preserved. – Article 152b**
  - EIOPA may in case of justified concerns about negative effects on policy holders, on its own initiative or on request of NSAs set up/coordinate collaboration platforms.
    - Where activities are of relevant in respect to the MS' market
    - A notification by the home NSA has been made of deteriorating financial conditions
    - The matter has been referred to EIOPA
  - Requirements on enhanced supervisory cooperation/information exchange between home/host NSA in line with Art 152ab apply also to NSAs participating in collaboration platforms irrespective of whether the insurance undertaking is carrying out significant cross border activities.
  - EIOPA role within collaboration platform: Introduce the possibility for EIOPA to invite the home supervisor to trigger and lead a joint on-site inspection. Own-initiative binding mediation would be strictly limited to issues related to information sharing.
  - EIOPA would also have the power to disclose information on collaboration platforms, including the name of the company but the insurer should have the 'right to be heard' prior to that publication.

- For any cross-border insurer, direct request of information by host authorities to insurance companies can only occur where the home authority fails to provide in a timely manner that information.- Article 153.