

## **Consultation document**

on the Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

### **Important note**

This document is a working document of DG Internal Market and Services of the European Commission (the Commission Services), for the purpose of obtaining views of interested parties. It does not purport to represent or pre-judge the views of the Commission and/ or the formal proposals of the Commission, regarding the matters covered in the consultation paper, which are expected to be published in the form of a Commission proposal in June 2011.

The discussions on the framework for Solvency II were concluded last year. The adopted Directive (Directive 2009/138/EC, the Solvency II Framework Directive) was published in the Official Journal on 17 December 2009. The development of the Solvency II Framework Directive was subject to lengthy consultation and a thorough impact assessment, which concluded that the EU should adopt an economic risk-based approach to the supervision of insurance and reinsurance undertakings (undertakings) and insurance and reinsurance groups (groups).

Solvency II follows the "Lamfalussy" approach, whereby the EU prudential framework is divided into three hierarchical levels. The Solvency II Framework Directive (level 1) identifies a number of areas where the Commission is required to develop implementing measures (level 2) to provide further technical detail to elaborate the level 1 principles. The Commission Services are currently developing these level 2 implementing measures.

The purpose of this public consultation is not to revisit the conclusions drawn in the impact assessment undertaken on the Solvency II Framework Directive. Instead, this public consultation aims at having valuable insights, supported by quantitative and qualitative evidence, on the impacts, costs and benefits to support the policy decision-making process for the level 2 implementing measures. The consultation paper also seeks stakeholders' views on the potential impact that the policy decisions on the detail of the level 2 implementing measures could have on the pricing, design and availability of insurance products, the corresponding effects for consumers and the wider social or economic impacts. For this reason, we welcome views of consumers, investors and undertakings.

Many undertakings and groups recently participated in the fifth quantitative impact study (QIS5). The purpose of QIS5 was primarily to test the impact of an approach to the quantitative requirements in Solvency II (often referred to as Pillar 1). While the Commission Services are interested in any quantitative data that was not submitted as part of QIS5, the intention is to use this consultation paper primarily to gather views on the wider market impacts of suggested approaches and to seek views that are of a more qualitative nature so as to not repeat the QIS5 exercise.

This consultation paper is not intended to pre-empt the results of QIS5. Policy decisions on the level 2 implementing measures will be based on both the results from QIS5 and the outcome of this consultation.

## Completing the questionnaire

The questionnaire is composed of 4 sections. Respondents may respond to all questions or only to specific sections or questions that are of particular interest. The sections are:

**SECTION 1** – Context

**SECTION 2** – Policy Issues (questions 1 to 36)

**SECTION 3** – Market and Products (questions 37 to 45)

**SECTION 4** – Social and Economic Impacts (questions 46 to 57).

For the purpose of responding to the questions in Section 2 (questions 1 to 36), stakeholders should cross refer to Annex 1, which is the **List of Policy Issues and Options for the level 2 Impact Assessment of Solvency II**.

Stakeholders' may also wish to consult the following **background information**:

- The Solvency II Framework Directive (Directive 2009/138/EC)
- The Impact Assessment Report for the Solvency II Framework Directive Proposal
- The technical specifications for the fifth quantitative impact study (QIS5)
- The technical specifications for the fourth quantitative impact study (QIS4)
- The Call for Advice to CEIOPS' contribution to the Impact Assessment of the level 2 implementing measures for Solvency II
- CEIOPS' final level 2 advice

These documents are available at:

[http://ec.europa.eu/internal\\_market/insurance/solvency/index\\_en.htm](http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm)

<https://www.ceiops.eu/publications/sii-final-l2-advice/index.html>

This consultation is open until 26 January 2011. Responses should be sent to [markt-solvencyII@ec.europa.eu](mailto:markt-solvencyII@ec.europa.eu). The Commission Services will publish all responses received on the Commission's website unless confidentiality is specifically requested. For administrative purposes please clearly state, in the email text, the following information:

- Name of respondent organisation/company/natural person
- Contact person and function
- Contact details
- Country
- Field of activity of respondent (e.g. life insurer, non-life insurer, health insurer, reinsurer, investor, financial analyst, consumer)

# 1. Context

The Commission Services are currently developing the level 2 implementing measures that will elaborate the principles that have been set out in the Solvency II Framework Directive<sup>1</sup>. The Solvency II Framework Directive was subject to a thorough impact assessment (level 1 Impact Assessment). The Commission's proposal for level 2 implementing measures will be accompanied by a full Impact Assessment. However, this impact assessment will not reconsider the level 1 Impact Assessment. Instead, the level 2 impact assessment will be used to inform the policy decisions on the technical detail that will be introduced at level 2. The policy options will be assessed against operational objectives that are similar to those used to assess the policy options at level 1<sup>2</sup> in order to determine which is the most effective and efficient means by which the stated objectives can be achieved.

The majority of the consultation paper contains a discussion of each of the policy issues identified. The list of policy issues and options has been developed by the Commission Services and the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) and agreed with Member States at the level of the European Insurance and Pensions Committee (EIOPC) and is annexed to this consultation paper. The Commission asked CEIOPS<sup>3</sup> in March 2009 to include, as part of its final technical advice on the level 2 implementing measures (CEIOPS' final advice), an analysis and comparison of the policy options in respect of the 17 policy issues identified. This consultation paper summarises CEIOPS' analysis and preferred policy option.

The Commission commissioned Deloitte to undertake an external independent impact assessment study (Deloitte's report). This contains a multi-dimensional analysis of policy issues 1 to 6 and a stand-alone analysis of policy issues 7 to 11. Policy issues 11 to 17 were scoped out of Deloitte's work. The Commission Services' currently intends to publish Deloitte's report as an annex to the Impact Assessment report that will accompany the Commission's proposal for level 2 implementing measures in June 2011. A summary of Deloitte's analysis and conclusions with respect to each policy issue has been included in this consultation paper. Deloitte's analysis was largely based on the QIS4 approach and 2007 year-end data. Consequently some of the conclusions may no longer be valid due to changes in economic conditions. Stakeholders' are invited to provide views on the impact that changing economic conditions may have had on the conclusions drawn by Deloitte.

The Commission recently asked CEIOPS to run the fifth Quantitative Impact Study (QIS5). The results from QIS5 will provide valuable input to help refine the calibration of the Solvency Capital Requirement standard formula, as well as the requirements for valuation, including technical provisions, and own funds in the level 2 implementing measures. The Commission Services are keen to avoid an overlap between QIS5 and this consultation paper. As such stakeholders are primarily asked to provide views on the wider market impacts that the decisions at level 2 may have. Views of a more qualitative nature should, however, be supported where appropriate with empirical evidence. Stakeholders are also invited to provide quantitative data where this was not submitted as part of QIS5.

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<sup>1</sup> Directive 2009/138/EC

<sup>2</sup> A summary of the operational objectives is annexed to the consultation paper.

<sup>3</sup> [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/solvency2/call\\_for\\_advice\\_from\\_CEIOPS\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/call_for_advice_from_CEIOPS_en.pdf)

The level 1 Impact Assessment, contained an analysis of the impacts of the Solvency II regime on insurance markets and products and on society and the economy. The remaining part of this consultation paper asks for stakeholders' views on the additional and/ or incremental effects that the Commission's policy decisions for the level 2 implementing measures may have on these impacts.

## 2. Policy Issues

This section should be read in conjunction with the List of Policy Issues and Options for the level 2 Impact Assessment of Solvency II (Annex 1) and the Summary of Objectives (Annex 2).

### 1. Technical provisions – best estimate – risk-free interest rate curve

Solvency II requires undertakings to set up technical provisions for their insurance<sup>4</sup> obligations. In line with a market consistent approach to valuing all assets and liabilities, technical provisions are valued on a transfer value basis. Where technical provisions are not calculated as a whole, their value is equal to the sum of a best estimate and a risk margin. The best estimate is equal to the probability-weighted average of future cash-flows, taking into account the time value of money using the relevant risk-free interest rate term structure. The risk-free interest rate is the interest rate that can be obtained by investing in financial instruments with no default risk. Although a truly risk-free asset exists only in theory, in practice a proxy for the risk free rate may be derived based on either government bond curves or swap curves for the currency of the insurance obligations.

Information from financial markets suggests that investors can earn a higher rate of return if they are able and willing to relinquish the ability to cancel or sell an asset at short notice without penalty. This additional rate of return is referred to as the “illiquidity premium”. However, questions remain on the extent to which insurance liabilities should be considered illiquid for the purpose of Solvency II and, if the liabilities are considered illiquid, the extent to which this should be reflected in the rate used to discount those liabilities.

The relevant risk-free interest rate term structure that should be used must be specified at level 2. The policy issue is whether swaps or government bonds should be used as a starting point and whether and how this starting point should be adjusted. It is also necessary to decide whether the discount rates should include an illiquidity premium and for which insurance liabilities. Finally, the method used to calculate the discount rate needs to be consistent between different currencies, including those without a government bond or swap market.

The different options are the following ones: use the swap curve with or without an adjustment (respectively option 3 and option 1), use the government bonds curve with or without an adjustment (respectively option 4 and option 2) or use a combination of the previous options (option 5).

CEIOPS' final advice proposed a three stage approach based on option 2, as follows:

1. the government bonds curve without adjustment is chosen to the extent possible;

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<sup>4</sup> References to insurance throughout the document also include reinsurance, unless otherwise stated.

2. the government bonds curve with adjustment is chosen when adjustments are needed because the government bonds do not meet certain criteria; and
3. swaps curve with an adjustment or a curve derived from other financial instruments is chosen if government bonds are not available or the adjustments to the government bonds are not sufficient.

CEIOPS noted that this three stage approach ensures that the method used to calculate the discount rate is consistent between different currencies. CEIOPS recommended not allowing for an illiquidity premium.

Deloitte's report found that the use of government bonds curve would lead to higher capital requirements whereas the use of swaps curve with an adjustment would lead to lower capital requirements (this could however depend on the economic environment). Deloitte also suggested that the use of government bond rates with no illiquidity premium could lead to market dislocation in the corporate bond market, as it may result in insurers holding less of these instruments.

In QIS5, discount curves for 31 currencies were specified. The default approach was to use interest rate swaps and, where this was not possible, government bonds. An adjustment for credit and basis risk was made. These curves included an illiquidity premium for all insurance liabilities, depending on the features of the liabilities which are classified in 3 buckets.

The Commission Services' current view would be to choose the same two stage approach based on option 3 as tested in QIS5 and to allow for an illiquidity premium for all insurance liabilities in situations of stressed liquidity in the financial markets. In order to ensure a harmonised approach to the calculation of technical provisions, which is more straightforward for small and medium sized undertakings, the discount curves for all relevant currencies would be published by the European Insurance and Occupational Pension Authority<sup>5</sup> (EIOPA).

**Question 1: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

## **2A. Technical provisions – risk margin – Cost-of-Capital rate**

The risk margin should ensure that the value of technical provisions is equivalent to the amount that an undertaking would be expected to require in order to take over and meet the insurance obligations of another undertaking. The risk margin is calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement (SCR) necessary to support the insurance obligations over the lifetime thereof. The Cost-of-

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<sup>5</sup> The Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority will create the new EIOPA Authority from 1 January 2011. EIOPA will replace CEIOPS.

Capital rate is the rate equal to the additional rate, above the relevant risk-free interest rate, that an undertaking would incur holding an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance obligations over the lifetime thereof.

The Solvency II Framework Directive<sup>6</sup> requires the calibration of the Cost-of-Capital rate to be set out in level 2 implementing measures. The policy options identified are as follows: to retain the 6% Cost-of-Capital rate tested in QIS4 (option 1), to choose a lower rate (option 2) or to choose a higher rate (option 3).

CEIOPS' final advice recommended a Cost-of-Capital rate of at least 6%, on the basis that this most closely represents the market cost of capital. A lower rate would result in technical provisions which are not sufficient to enable portfolio transfer, while a higher rate might require undertakings to set up technical provisions which are unnecessarily high.

Deloitte's report compared the impact on technical provisions and on financial requirements<sup>7</sup> of a Cost-of-Capital rate of 6% (option 1) with a rate of 4% (representing option 2) and a rate of 8% (representing option 3). For non-life insurance business a rate of 4% is estimated to lead to a decrease of between 0.6% and 1% of undertaking's financial requirements, while a higher rate would lead to an increase of between 0.6% and 1.2% in undertaking's financial requirements. With regard to life insurance, a small impact on financial requirements is expected for most product types, although for certain annuity business the impact is believed to be moderate. With regard to health insurance the impact depends on the duration of the obligations. The impact on technical provisions would be small for short-term obligations, but more significant for long-term obligations.

The Commission Services' current view would be to set the Cost-of-Capital rate at 6%.

**Question 2: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

**Question 3: Do you agree that a 6% Cost-of-Capital rate would closely reflect the cost of providing an amount of eligible own funds equal to the SCR necessary to support the insurance obligations over the life time thereof? (Please provide reasons)**

## **2B. Technical provisions – risk margin – diversification**

<sup>6</sup> Article 86 of Directive 2009/138/EC

<sup>7</sup> Deloitte defines financial requirements as the sum of the technical provisions and the Solvency Capital Requirement under Solvency II.

An important assumption in the calculation of the risk margin relates to the degree of diversification that should be reflected in the SCR needed to support the insurance obligations. The policy options identified in relation to this issue are as follows: to assume that the risk margin can be calculated allowing for the diversification of a well-diversified undertaking (option 1), the same diversification of the undertaking for which the calculation is made (option 2) or diversification within, but not across, the lines of business (option 3).

CEIOPS' final advice recommended option 3. The reason given for this recommendation was that options 1 and 2 result in technical provisions which would not be sufficient to ensure the transferability of the underlying insurance obligations.

Deloitte's report concluded that for non-life insurers, allowing for diversification in the risk margin across lines of business (as under option 1 and 2), would be expected to have a very small impact on financial requirements. A similar impact is expected for most markets in the case of health insurance. However, in markets where health insurance can only be provided by specialised insurers, the restricted amount of diversification means that there is no basis for option 1. No firm conclusions were drawn by Deloitte for life insurers.

The Commission Services' current view would be to choose option 2 for level 2 implementing measures and this approach was tested in QIS5. This would ensure the transferability of insurance obligations in relevant situations, in particular where a line of business is transferred to an undertaking that is as diversified as the original undertaking or where the whole business is transferred to an empty undertaking.

**Question 4: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

### **3. Own funds – quantitative limits for SCR and MCR**

Solvency II imposes quantitative limits on the own funds to be used to meet the SCR and the Minimum Capital Requirement (MCR). The Solvency II Framework Directive<sup>8</sup> sets the minimum limits in relation to the MCR<sup>9</sup> and the SCR<sup>10</sup>, but allows stricter limits to be introduced in level 2 implementing measures.

The policy options identified vary the minimum amount of Tier 1 own funds required to cover the SCR (between 1/3 and 50%), the maximum amount of Tier 3 own funds permitted to cover the SCR (between 15% and 1/3) and the minimum amount of Tier 1 own funds required to cover the MCR (between 50% and 100%). A combination of options is also permitted.

<sup>8</sup> Article 98 of Directive 2009/138/EC

<sup>9</sup> At least 50% of the MCR must be met with Tier 1 and ancillary own funds are not permitted to meet the MCR.

<sup>10</sup> At least one third of the SCR must be met with Tier 1 and no more than one third can be met with Tier 3.

CEIOPS' final advice favoured option 5 (a combination of options) which sets the minimum amount of Tier 1 own funds required to cover the SCR at 50%, the maximum amount of Tier 3 own funds permitted to cover the SCR at 15% and the minimum amount of Tier 1 own funds required to cover the MCR at 80%. CEIOPS considered that this option maximises policy holder protection, by requiring high quality capital, without increasing unjustifiably the cost of capital. The need for an effective ladder of supervisory intervention is important and is the reason why CEIOPS dismisses the option that would require all of the MCR to be met with Tier 1 own funds.

Deloitte's report refers to the QIS4 results which showed that 95% of insurers' own funds were at the time in the form of Tier 1. However, Deloitte expects that currently undertakings have greater proportions of tiers 2 and 3 own funds than was evidenced in QIS4. The results of QIS5 are expected to provide more recent and accurate details of own funds. If the results reveal lower proportions of Tier 1 own funds, then the policy option that requires all of the MCR to be met with Tier 1 own funds may require undertakings to increase the amount of Tier 1 own funds.

The Commission Services' current view would be to follow option 5. This was the approach tested in QIS5.

**Question 5: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards;**
- **promoting compatibility of prudential supervision of insurance and banking; and**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

**Question 6: In your view, what impacts would the Commission Services' suggested approach have on the following:**

- **cost of own funds**
- **capital raising or capital reduction**

**(Please provide reasons and examples)**

#### **4. Procyclicality – Pillar II dampener**

In the event of an exceptional fall in financial markets, the Solvency II Framework Directive allows supervisory authorities to extend the time period within which undertakings are required to re-establish the level of eligible own funds covering the SCR. The policy issue relates to the maximum period of time which supervisory authorities should be able to give undertakings to re-establish the level of eligible own funds covering the SCR in the event of an exceptional fall in financial markets. The four policy options considered range from 15 months to a maximum total of 60 months.



CEIOPS' final advice recommended setting the maximum extension period at a total of 30 months, i.e. being 6+3 (in normal circumstances) plus up to another 21 months of extension in case of an exceptional fall in financial markets. This represents option 3.

Deloitte's report commented that where the choice of the time period allowed for the Pillar II dampener is more liberal (between 36-60 months) and insurers have more time to adjust to the fall in financial markets, there is expected to be more (cross-border) business activity, which will boost a unified European insurance market. However, a more lenient time period might lead to lower capital levels overall, which could have a more negative impact on policy holders than stricter time periods. The competitiveness of EU insurers is likely to be promoted when standards are more lenient, as it will attract investors and further growth, as the industry is likely to be more stable and able to absorb more market risk.

The fact that QIS5 is being conducted in a post-crisis scenario may give insights into the relevance of the Pillar II dampener as it is currently conceived.

The Commission Services' current view would be to set the maximum extension period at a total of 30 months in the level 2 implementing measures. It is also proposed that an open list of the external and entity-specific factors to be taken into account by supervisory authorities when deciding whether and for what time period to grant any such extension be provided.

**Question 7: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **harmonising supervisory powers, methods and tools;**
- **promoting compatibility of prudential supervision of insurance and banking; and**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

**Question 8: Should the list of factors to be taken into account by supervisory authorities when deciding whether to grant such a decision be left open? (Please provide reasons)**

## **5. Supervisory reporting – content, form and modalities**

Supervisory authorities require undertakings to submit regular information which is necessary for the purpose of supervision. The Solvency II Framework Directive requires this information to be proportionate, accessible, complete in all material aspects, relevant, reliable, timely and comprehensible<sup>11</sup>. Level 2 implementing measures will specify the content and form of the information required in order to ensure an appropriate level of convergence in supervisory reporting.

Since developing the list of policy issues and options, it has been agreed that the quantitative reporting templates should form part of level 3. Consequently the options for the content of

<sup>11</sup> Article 35 of Directive 2009/138/EC

the quantitative reporting templates in the report to supervisors (factor A of policy issue 5<sup>12</sup>) are no longer relevant for the level 2 discussions.

There are a number of factors which have to be considered when determining the optimal reporting requirements for both quantitative and qualitative information and this will ultimately depend on the interplay between the level of qualitative and quantitative details, the level of assurance (external audit), the frequency and the extent of harmonization. Given the close interplay between these various factors, CEIOPS analysed the different policy options in 5 scenarios (set out below). CEIOPS' final advice recommended scenario 3.

A*.	Content of the qualitative aspects of the Report to the Supervisor (RTS)
Option 1	The RTS on every occasion contains complete information on the subjects specified in section 3.4.3 of the July 2009 CP
Option 2	Undertakings will provide a full report for the first year and thereafter on a frequency to be established by the supervisory authority, depending on the risk profile of the undertaking. In the intervening years, undertakings will provide information only on those topics (specified in section 3.4.3 of the July 2009 CP) where material changes have occurred, or state that no material changes have occurred.

B.	Frequency
Option 1	All data is provided quarterly
Option 2	Core quantitative data is provided quarterly, while all quantitative reporting templates and all qualitative data are provided annually
Option 3	All data is provided annually unless more frequent submission is required in the Directive

C.	Level of assurance
Option 1	All quantitative data are externally audited annually
Option 2	Specific quantitative data are externally audited annually, with the remainder unaudited

D.	Reporting format
Option 1	Standardised reporting formats for all information
Option 2	Free format reporting for all information
Option 3	Quantitative data in a standardised reporting format and qualitative data following a predefined order but in free format

	A*.	B.	C.	D.
Scenario 1	Option 2	Option 3	Option 2	Option 3
Scenario 2	Option 1	Option 2	Option 1	Option 2
Scenario 3	Option 2	Option 2	Option 2	Option 3
Scenario 4	Option 2	Option 1	Option 1	Option 1
Scenario 5	Option 1	Option 1	Option 1	Option 2

<sup>12</sup> Page 9 of Annex 1.

CEIOPS has carried out further work on reporting since providing their final advice in order to develop the reporting templates for level 3. Their initial views are that long reporting deadlines or less detailed reporting may give rise to ad hoc reporting requirements to bridge the information-gap that supervisors and political bodies may have. This is an important consideration in the assessment of the efficiency and effectiveness of reporting requirements.

Generating mandatory reporting information can be costly, which should be taken into account. This is particularly important in the light of the proportionality principle set out in the Solvency II Framework Directive, which requires provisions to be applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of undertakings<sup>13</sup>. Deloitte's report assessed the changes in administrative costs of the different scenarios on supervisory reporting and public disclosure designed by CEIOPS<sup>14</sup>. Administrative costs are defined as the costs incurred by businesses in meeting legal obligations to provide information on their action or production. It is important to distinguish business-as-usual costs (information that is collected and processed by the business regardless of legislation) and administrative burden (information that is collected because of a legal obligation). Deloitte separated their findings into implementation costs and on-going costs. Implementation costs are costs that undertakings will initially incur in order to build new reporting capabilities. On-going costs are the annual costs incurred as part of the business-as-usual reporting requirements under the new regime.

Deloitte's report found that implementation costs were likely going to be a significant driver of cost because the administrative burden flowing from them is expected to be significant. However, any transition to a new regime is likely to entail a certain level of implementation costs. In respect of on-going costs, Deloitte assessed the five CEIOPS scenarios and concluded that scenario 3 is significantly less costly and burdensome than the other scenarios.

Deloitte also analysed the impact of supervisory reporting on cross-border groups and concluded that groups are approaching the reporting requirements from a centralised, top-down group perspective "which is likely to significantly reduce the overall estimate of qualitative reporting for cross-border groups."

The Commission Services' current view is that scenario 3 would best meet the stated objectives. The Commission Services would suggest following an approach in level 2 implementing measures whereby the reporting requirements would be based on the information that is publicly disclosed in the Solvency and Financial Condition Report (SFCR) and supplemented with an additional report to supervisors which includes confidential and proprietary information. This would ensure consistency in the reporting requirements and reduce the burden for industry.

In relation to insurance groups, the Commission Services currently have the view that the same requirements that apply to the individual undertakings in terms of frequency, level of assurance and extent of harmonization should also be applicable to groups. However, some differences will exist in relation to the content of qualitative and quantitative information to take into account specific information needs in relation to groups.

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<sup>13</sup> Article 29 of Directive 2009/138/EC.

<sup>14</sup> Deloitte's impact assessment considers the overall reporting requirements (supervisory reporting together with public disclosure), as such the discussion of policy issue 6 should be read in conjunction with the discussion on policy issue 7.

**Question 9:** Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- introducing proportionate requirements for small undertakings;
- harmonizing supervisory reporting;
- promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB; and
- ensuring efficient supervision of insurance groups and financial conglomerates.

(Please provide reasons and examples. If you do not agree, which combination of options in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)

**Question 10:** The Commission Services are currently of the view that, in line with the proportionality principle, the level 2 implementing measures should only require material and/ or relevant information to be provided. Do you agree with this approach? (Please provide reasons, including specific suggestions on how to implement the proportionality principle with respect to reporting requirements, how and who should determine what information is material and/ or relevant)

**Question 11:** Do you have any suggestions on which specific quantitative data should be subject to external audit? (Please provide reasons)

**Question 12:** Do you have background information or evidence that groups are approaching the reporting requirements from a centralised, top-down group perspective? (Please also provide views on whether groups should be encouraged to adopt this approach)

## 6. Public disclosure – content, form and modalities

Public disclosure of solvency and financial information promotes market discipline, improves the accountability of firms, and provides information for all interested parties and policy holders. Over time, the standards of public disclosure should improve as 'best practice' develops. However, the level of public disclosure needs to be prescribed in level 2 implementing measures. The Solvency II Framework Directive requires undertakings to publicly disclose annually a SFCR<sup>15</sup> and sets out high level requirements on the information to be disclosed. The compatibility, where appropriate, with other reporting rules and the need for proportionate requirements for small firms are particularly important factors to consider.

When setting out public disclosure requirements both the content and how public disclosure is achieved need to be addressed. CEIOPS' final advice recommended the option where the level of detail in the SFCR is specified in a concrete way and a minimum content of the information to be disclosed is defined. In relation to how public disclosure is achieved CEIOPS' final advice concluded that the specification of the structure of the document is more important than where the document will be disclosed.

Deloitte's report included an administrative burden analysis which covered both supervisory reporting and public disclosure requirements. Therefore, conclusions similar to those reported above can also be drawn for public disclosure. In particular, while seen as a significant change

<sup>15</sup> Article 51 of Directive 2009/138/EC

from the current regime, the overall incremental cost associated with public disclosure is not seen as being a significant impact where solvency, capital and risk disclosure tend to be similar to those requirements set out in other statutory reporting requirements (such as IFRS 7 Financial Instruments: Disclosure).

The Commission Services' current view would be to follow CEIOPS' advice in relation to content, whereas in relation to how public disclosure is achieved the Commission Services would suggest requiring the SFCR to be disclosed, where possible, on the undertaking's website or, where this is not possible, on a trade association's website. Where undertakings do not disclose their SFCR by these means, they would have to make available to any person an electronic copy of their report.

**Question 13: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing proportionate requirements for small undertakings;**
- **harmonizing supervisory reporting;**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

**Questions 14: The current approach favoured by the Commission Services would be to list a number of items which would need to be put in the public domain. Some stakeholders argue that the SFCR should contain much less information, so that it is understandable by policy holders, while others support disclosure of information directed at a much wider audience. Do you have views on:**

- a) **what stakeholders should be addressed?**
- b) **what are the areas on which stakeholders need information?**
- c) **how detailed has it to be?**

**Questions 15: Solvency II will be based on an economic valuation of all assets and liabilities. The current approach favoured by the Commission Services would be to require public disclosure of a number of aggregated key figures arising from solvency valuation and their material differences with the accounting valuation. Do you support that approach? (Please provide reasons and suggestions on how precise such information should be and how it should be presented to be understood well by markets)**

## **7. Treatment of holdings in participations and subsidiaries**

The Solvency II Framework Directive envisages that the treatment of participations and subsidiaries (known collectively as related undertakings) will be developed in level 2 implementing measures. Level 2 implementing measures are required on the treatment of participations in financial and credit institutions<sup>16</sup> with respect to the determination of own funds. Risks relating to holdings in related undertakings will be reflected in the SCR standard formula. Risks relating to holdings in related undertakings will be reflected in the SCR

<sup>16</sup> Defined in Article 92(2)(a) of Directive 2009/138/EC

standard formula with a treatment that should take into account the likely reduction in the volatility of the value arising from the strategic nature of investments in related undertakings and the influence exercised by the parent company on those undertakings<sup>17</sup>. Where undertakings are part of a group, the Solvency II Framework Directive sets out the approach for calculating group solvency in relation to these undertakings.

The five policy options are:

Option 1	Apply a differentiated equity stress to all related undertakings
Option 2	Apply a differentiated equity stress to all non-financial and (re)insurance holdings in related undertakings. Apply a different approach to holdings in financial and credit institutions (e.g. deduction/aggregation).
Option 3	Apply a differentiated equity stress to all non-financial holdings in related undertakings. Apply an alternative approach to (re)insurance holdings, which makes use of the additional information available in these cases to determine the holding's contribution to the overall risk profile of the undertaking. Deduct holdings in financial and credit institutions.
Option 4	Apply a differentiated equity stress to all non-financial subsidiaries. Apply a standard equity stress to non-financial participations, which are not subsidiaries. Apply an alternative approach to (re)insurance holdings in subsidiaries and participations, which makes use of the additional information available in these cases to determine the holding's contribution to the overall risk profile of the undertaking. Deduct holdings in financial and credit institutions
Option 5	A combination of options

CEIOPS' final advice expects option 1 to have the lowest impact on the own funds. Deloitte's report reached broadly the same conclusion, but suggests that option 2 may have a lower impact than option 1 depending on the nature of the alternative approach. CEIOPS' final advice highlighted that while lower own funds may lead to a lower cost of capital and potentially lower (or at least not increased) premiums for policy holders, the long-term benefits to policy holders of undertakings having more available own funds to absorb unexpected losses should not be ignored.

CEIOPS' final advice distinguished between related undertakings included and excluded from the scope of the group. For those within the scope of the group, CEIOPS' preference is for option 5 a combination of policy options that combines an equity stress for holdings in non-financial, non-regulated undertakings, deduction of holdings in financial and credit institutions and financial non-regulated undertakings and insurance or reinsurance undertakings. Related undertakings outside the scope of the group should be deducted at solo level assuming that the reason for their exclusion from the group is also relevant at solo level.

Deloitte's report indicates that undertakings continuously review their corporate structure in order to maximise their efficiency from an accounting, regulatory or tax perspective and that Solvency II is likely to trigger such a review. Consequently, one of the impacts of the choice of policy options may be a change in the corporate structure (for example transforming participations into branches or restructuring to become a financial conglomerate) of some undertakings where the benefits of such a change outweigh the costs. The impact of the

<sup>17</sup> Article 111(1)(m) of Directive 2009/138/EC.

different options will vary depending on the relative size and nature of the different related undertakings within the overall group structure.

QIS5 tested option 5, an approach that combines the policy options of deduction of holdings in financial and credit institutions, a differentiated (lower) equity stress for strategic participations in other related undertakings, a standard equity stress for non-strategic participations and a 100% equity stress for undertakings excluded from the group. Additional quantitative information has been collected on the value of participations, the level of its own funds and details of its capital requirements (where relevant). The Commission Services' current view is that the choice between the options should be based on further analyses, in particular of the QIS5 results and the outcome of this consultation. A combination of options (option 5) would seem a likely outcome. Rather than the QIS5 approach of applying a 100% equity stress for undertakings excluded from the group, holdings in these related undertakings would be likely to be valued at nil.

**Question 16: Do you consider that the approach tested in QIS5 would be the most efficient and effective in order to achieve the objectives of:**

- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards;**
- **promoting compatibility of prudential supervision of insurance and banking; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

**Question 17: Do you agree with Deloitte's conclusion that the choice of policy option may cause some undertakings to change their corporate structure? (Please provide reasons and examples)**

**Question 18: In terms of alternative approaches for holdings in certain regulated related undertakings (financial and credit institutions and insurance and reinsurance undertakings), would you support an approach which makes use of the additional information available about these holdings to determine their contribution to the overall risk profile of the undertaking? (Please give suggestions of possible approaches)**

## **8. SCR standard formula – equity risk – Pillar I dampener**

One component of the standard formula for the calculation of the SCR is the symmetric adjustment mechanism in the equity risk sub-module ("Pillar I dampener"). The symmetric adjustment is based on a function of the current level of an appropriate equity index and a weighted average level of that index over an appropriate period of time which should be the same for all undertakings. The Pillar I dampener enables undertakings to smooth the impact of a change in the level of equity markets on its SCR over a period of time.

The level 2 implementing measures require the appropriate period of time (expressed in months) over which to calculate a weighted average level of that index to be specified. The six policy issues identified are as follows: less than 3 months (option 1), between 3 and 6

months (option 2), between 6 and 12 months (option 3), exactly 12 months (option 4), between 12 and 36 months (option 5) or more than 36 months (option 6).

CEIOPS' final advice recommended option 4 on the basis that it strikes the right balance between the anti-cyclical objectives of the adjustment mechanism and the risk-sensitivity of the equity risk sub-module.

Deloitte's report concluded that the longer the time period prescribed, the lower the volatility of the adjustment. The shorter the time period, the lesser the scope for companies to be in breach of capital adequacy rules for longer periods of time, but the more likely industry stability would be reduced. The impact of the choice of options on health and non-life insurers was deemed neutral on the basis that exposures to equity are low for healthcare and non-life insurers (except in certain markets). The impact on life insurers would vary by products.

In QIS5, the equity stress was calculated with a symmetric adjustment based on a time period of 36 months. The Commission Services' current view would be to choose a time period of 36 months (option 5) for level 2 implementing measures.

**Question 19: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **harmonising supervisory powers, methods and tools;**
- **promoting compatibility of prudential supervision of insurance and banking; and**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

## **9. SCR standard formula – loss-absorbing capacity of technical provisions**

One component of the standard formula calculation of the SCR is the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes<sup>18</sup>. In relation to technical provisions the adjustment should reflect potential compensation of unexpected losses through a decrease in technical provisions. The adjustment must take account of the risk mitigating effect provided by the future discretionary benefits of insurance contracts, to the extent that undertakings can establish that the reduction in such benefits may be used to cover unexpected losses when they arise<sup>19</sup>.

Three policy options have been identified to quantify the adjustment in relation to technical provisions: an adjustment as a fixed percentage of technical provisions (option 1), an approach where the loss-absorbing capacity is estimated at the level of each sub-module or module and the adjustment derived from that information (option 2) and an approach where the loss-absorbing capacity is estimated on the basis of a single scenario that reflects all the risks captured in the SCR standard formula (option 3).

<sup>18</sup> Article 103(c) of Directive 2009/138/EC.

<sup>19</sup> Article 108 of Directive 2009/138/EC.



CEIOPS' final advice recommended not to apply option 1 because it is not sufficiently risk-sensitive to capture the loss-absorbing capacity of technical provisions and may jeopardise the protection of policy holders. CEIOPS proposed that the choice between options 2 and 3 be based on the results of QIS5.

Deloitte's report concluded that neither option 2 nor 3 is superior in all aspects. Advantages of option 3 are that less stress calculations are required to calculate the adjustment; it avoids double counting of the loss-absorbing capacity and better captures the non-linearity of the loss-absorbing capacity. An advantage of option 2 is that it was tested in QIS3 and QIS4.

The Commission Services' current view would be to choose between options 2 and 3 based on further analyses, in particular of the QIS5 results and the outcome of this consultation.

**Question 20: Is option 2 or 3 the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings.**
- **harmonising supervisory powers, methods and tools; and**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA.**

**(Please provide reasons and examples)**

#### **10A. SCR standard formula – diversification effects – correlation parameters**

The non-life underwriting risk module of the SCR standard formula includes a non-life premium and reserve risk sub-module to capture the underwriting risk that does not stem from extreme or exceptional events (catastrophe events)<sup>20</sup>.

The sub-module is calculated by aggregating standard deviations of lines of business by means of correlation matrices. For this purpose a correlation parameter is specified for each pair of lines of business which reflects the degree of dependence between them. The policy options for the choice of correlation parameters are: the correlation parameters used in QIS4 (option 1), lower parameters (option 2) or higher parameters (option 3).

CEIOPS' final advice recommended the correlation parameters set out in option 1. However, CEIOPS also suggested that those parameters could be revised, once sufficient data for a detailed analysis of those parameters becomes available.

Deloitte's report compared the impact of the three options on financial requirements. The correlation parameters for option 2 were set at 0.1 and at 0.75 for option 3. Deloitte concluded that changing the assumed diversification levels between lines of business has little effect on financial requirements. For undertakings writing a diverse book of risks, option 2 would reduce the impact of a change in financial requirements from Solvency I to Solvency II by approximately 3 to 4 percentage points, while option 3 would increase it by approximately 4 to 4.5 percentage points, both compared to option 1.

The approach followed for QIS5 was option 1 and the Commission Services' current view would be to choose option 1 for the level 2 implementing measures.

<sup>20</sup> Article 105(2) of Directive 2009/138/EC.

**Question 21: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings.**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

#### **10B. SCR standard formula – diversification effects – geographical diversification**

Undertakings writing geographically diversified business are likely to be exposed to lower premium and reserve risk than undertakings exposed to geographically concentrated risk. Level 2 implementing measures must specify whether and how this could be reflected in the non-life premium and reserve risk sub-module of the SCR standard formula.

The policy options include allowing for an adjustment factor for geographical diversification as specified for QIS4 (option 2), introducing a more granular segmentation to calculate the adjustment factor (option 3), or not recognising geographical diversification (option 1).

CEIOPS' final advice recommended that geographical diversification should not be explicitly recognised in the standard formula. The reason given for this approach was that an explicit recognition introduces unnecessary complexity in the calculation of the standard formula in view of the materiality of the reduction in the SCR that could be obtained.

Deloitte's report concluded that introducing geographical diversification benefits has a small or moderate impact on financial requirements, depending on the level of geographical diversification in the business written. Deloitte also noted that undertakings may find it difficult to separate their business by geographical region.

The Commission Services' current view would be to include an adjustment factor for geographical diversification in the non-life premium and reserve risk sub-module (option 2) and this approach has been tested in QIS5. In order to address practicability issues, it is suggested that the European regions should be less granular and the calculation of the adjustment factor made optional for undertakings.

**Question 22: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings.**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

## **11. SCR internal models – integration of partial internal models**

The Solvency II Framework Directive only permits supervisory authorities to approve the use of a partial internal model to calculate the SCR where the design of the model is consistent with the general principles applicable for the calculation of the SCR. This is necessary to ensure that the partial internal model can be fully integrated into the standard formula. The question that arises is how to integrate partial internal models into the standard formula.

The three policy options identified are: using the coefficients prescribed by supervisors (option 1), using the techniques provided by supervisors or, if this is not possible or appropriate, those provided by the undertaking (option 2), using the techniques provided by the undertaking, unless the supervisory authorities do not approve them in which case techniques provided by the supervisory authorities should be used (option 3).

CEIOPS' final advice recommended option 2 as it provides the highest level of harmonisation, introduces proportionate requirements for small and medium-sized undertakings and provides more certainty in relation to modelling costs, regulatory arbitrage risk and the assessment of financial costs.

Deloitte's report also concluded that options 2 and 3 allow the flexibility needed to ensure the effective use of partial internal models. These options would give supervisors greater insights into risks run by undertakings, although this would depend on the extent to which undertakings are required to demonstrate the appropriateness of the integration technique. Option 2 provides less incentive for innovative techniques than option 3, but has the advantage that undertakings, primarily small ones, could benefit from developing benchmarking techniques if they are frequently updated.

The Commission Services' current view would be to follow option 2 and allow undertakings to use their own integration techniques, provided that they demonstrate that the correlation matrixes included in the standard formula or other integration techniques set out in implementing technical standards are not technically feasible or appropriate to comply with the principles set out in the Solvency II Framework Directive to calculate the SCR. Qualitative information on the different integration techniques that undertakings propose to use has been collected in QIS5.

**Question 23: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings;**
- **harmonising supervisory powers, methods and tools; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

## **12A. SCR standard formula – underwriting risk (other than catastrophe risk) arising from non-life insurance obligations**

The non-life underwriting risk module reflects the risk arising from the underwriting of non-life insurance contracts, in relation to the perils covered and the processes used in the conduct of business. It is calculated as a combination of the capital requirements for (at least) the following sub-modules: non-life premium and reserve risk and non-life catastrophe risk.

The policy issue relates to the precise method(s) to be adopted in level 2 implementing measures in order to properly reflect non-life underwriting risk (other than catastrophe risk) in the standard formula. This includes health underwriting risk (other than catastrophe risk)<sup>21</sup> for health insurance conducted on a similar basis to non-life insurance. This can be done either through the simulation of the impact of a pre-defined shock on the financial position of the undertaking (option 1: scenario based approach) or through a closed formula calibrated to a VaR at the 99.5% confidence level over a one-year period (option 2: factor based approach).

CEIOPS' final advice recommended option 2 as option 1 was considered not to be feasible given the heterogeneity of non-life underwriting risk. Option 1 was not considered to be proportionate for small and medium-sized undertakings. Option 2 was considered to be simple, understandable and relatively easy to calibrate and is consistent with approaches applied by other regulatory frameworks (ICA in the UK and Swiss Solvency Test). However, factor-based approaches would not be able to consider the full risk-mitigating effect of particular risk-mitigation arrangements such as non-proportional reinsurance or finite reinsurance and undertakings with activity in niche lines of business might find the calibration inadequate to their particular risk profile (but may be able to use undertaking specific parameters or internal models). Since CEIOPS produced its final advice, a Joint Working Group has been set up to refine the calibration of the premium and reserve risk factors in the non-life underwriting risk module of the SCR standard formula.

In QIS5, option 2 was followed with an adjustment factor for the risk-mitigating effect of non-proportional reinsurance. The Commission Services' current view would be to follow the same approach for the level 2 implementing measures.

**Question 24: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings; and**
- **harmonising supervisory powers, methods and tools.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

<b>12B. SCR standard formula – underwriting risk (other than catastrophe risk) arising from life insurance obligations</b>
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The life underwriting risk module reflects the risk arising from the underwriting of life insurance contracts, in relation to the perils covered and the processes used in the conduct of business. It is calculated as a combination of the capital requirements for (at least) the following sub-modules: mortality risk; longevity risk; disability – morbidity risk; life expense risk; revision risk; lapse risk; and life catastrophe risk.

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<sup>21</sup> The health underwriting risk module reflects the risk arising from the underwriting of health insurance contracts, following from both the perils covered and the processes used in the conduct of business.

The policy issue relates to the precise method(s) to be adopted in level 2 implementing measures in order to properly reflect life underwriting risk (other than catastrophe risk) in the standard formula. This includes health underwriting risk (other than catastrophe risk)<sup>22</sup> for health insurance conducted on a similar basis to life insurance. This can be done either through the simulation of the impact of a pre-defined shock on the financial position of the undertaking (option 1: scenario based approach) or through a closed formula calibrated to a VaR at the 99.5% confidence level over a one-year period (option 2: factor based approach).

CEIOPS' final advice considered the conclusions of QIS2 and QIS4 and recommended option 1 because of its higher risk-sensitivity and better alignment with the calibration standards under Solvency II compared to option 2, even though option 2 would more likely provide a harmonized application of the method to calculate life underwriting risk.

In QIS5, option 1 was followed. The Commission Services' current view would be to follow the same approach for the level 2 implementing measures.

**Question 25: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings; and**
- **harmonising supervisory powers, methods and tools.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

<b>12C. SCR standard formula – underwriting catastrophe risks arising from insurance obligations</b>
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The policy issue relates to the precise method(s) to be adopted in level 2 implementing measures in order to properly reflect underwriting catastrophe risks in the standard formula (in the non-life, life and health underwriting risk modules). This can be done through the simulation of the impact of a pre-defined shock on the financial position of the undertaking (option 1: scenario based approach), through a closed formula calibrated to a VaR at the 99.5% confidence level over a one-year period (option 2: factor based approach), or through a combination of the previous options (option 3).

CEIOPS' final advice recommended option 1. The impact of catastrophe events was considered to be better captured by stress and scenario techniques rather than by static factor-based methods. Furthermore, their application would allow full recognition of the impact of risk mitigation techniques. However, CEIOPS recommended to refer to factor-based approaches in certain specific circumstances (e.g. exposures outside the EU – option 2) or to a combination for specific lines of business (e.g. "miscellaneous" – option 3).

The approach proposed in CEIOPS' advice was modified for QIS5 to make it more aligned with a scenario-based approach (option 1). The Commission Services' current view would be to follow option 1 for the level 2 implementing measures.

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<sup>22</sup> The health underwriting risk module reflects the risk arising from the underwriting of health insurance contracts, following from both the perils covered and the processes used in the conduct of business.

**Question 26: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **introducing proportionate requirements for small undertakings; and**
- **harmonising supervisory powers, methods and tools.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

### **13. SCR internal models – use test**

The Solvency II Framework Directive requires undertakings to demonstrate that their internal model is widely used, and plays an important role in their system of governance before it can be used to calculate the SCR. Level 2 implementing measures will prescribe further detail on how undertakings should demonstrate compliance with the use test and the minimum requirements that the system of governance should comply with.

Two policy options have been identified. Option 1 requires that, as a minimum, the internal model must be used at the top-most organisational level of the undertaking including allocating risk capital and/or taking strategic business decisions. Option 2 requires the internal model to be used at all levels of the organisation by defining in a comprehensive and mandatory manner the areas or processes where it should be used.

CEIOPS' final advice concluded that option 1 encourages good risk management and leads to a more risk-sensitive assessment of the SCR, but could result in problems if communication between different levels of the undertaking is not appropriate. Option 2 is more effective in providing harmonisation of supervisory powers, methods and tools, but the mandatory nature of the uses may result in undertakings artificially demonstrating the use of the internal model in decision-making, which may distract resources from more useful internal model development work. Their preferred approach is to combine the use of the internal model at all levels of the undertaking included in option 2 with the consideration of the undertaking's use of the internal model in decision-making, but without mandatory uses as in option 1.

QIS5 has collected qualitative information on undertakings' current uses of their internal models and how undertakings expect to satisfy the use test.

The Commission Services' current view would be to follow CEIOPS' recommendations and require undertakings to demonstrate that their internal model is fully integrated in the risk-management system, by using it throughout the organisation, without imposing a list of mandatory uses for the internal model (this represents a modified version of option 2).

**Question 27: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards; and**
- **harmonising supervisory powers, methods and tools.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

### **14. SCR internal models – statistical quality standards**

The Solvency II Framework Directive requires the methods used to calculate the probability distribution forecast to be based on current and credible information and realistic assumptions. Undertakings can use internal and/or external data complemented by expert judgment. Level 2 implementing measures will set out the standards for data quality and requirements on how expert judgment should be determined.

Four policy options have been identified. Option 1 requires firms to agree the uses of internal and external data and expert judgement with the supervisor on a case-by-case basis. Option 2 requires undertakings to have a data quality policy that determines the sources of data used, the use of expert judgement and their respective validations. Options 3 and 4 require a review by an independent third party before either allowing the use of expert judgement in all areas (option 3) or allowing it only where data is not available (option 4).

CEIOPS' final advice recommended option 2 on the basis that while options 1 and 2 are equally risk-sensitive, option 1 does not adequately harmonise supervisory powers, methods and tools.

The Commission Services' current view would be to follow the CEIOPS' recommendation in level 2 implementing measures. The final policy decision will depend on the results of QIS5, which has collected qualitative input on how the concept of data quality is currently used by undertakings in their internal models.

**Question 28: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards; and**
- **harmonising supervisory powers, methods and tools.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)**

## **15. Capital add-ons**

The Solvency II Framework Directive<sup>23</sup> permits the use of capital add-ons as a supervisory tool, in exceptional circumstances, where the risk profile of the undertaking deviates significantly from the assumptions underlying the SCR (risk-profile capital add-on) or the undertaking's system of governance deviates significantly from the required standards and the deviation prevents the undertaking from being able to identify, measure, monitor, manage and report risks (governance capital add-on). Level 2 implementing measures will set out the conditions for imposing a capital add-on and the methodology to be used for its calculation.

A distinction is made between risk-profile capital add-ons imposed where the undertaking uses the standard formula or an internal model to calculate its SCR. However, CEIOPS' final advice concluded that regardless of how the SCR is calculated, significant deviations should be determined in the same way. Their preference is for option 3, whereby supervisors use a fixed percentage of the overall SCR as a reference value (i.e. a rebuttable presumption that the deviation is significant), but are able to depart from this subject to harmonised criteria. They advised that a higher percentage value at which point the deviation will always be presumed to be significant should also be provided for.

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<sup>23</sup> Article 37 of Directive 2009/138/EC

The Commission Services' current view would be to follow option 3. Criteria would be set for determining when there has been a significant deviation for risk profile and governance capital add-ons. For risk profile capital add-ons, 10% would be considered a suitable reference value, with the upper threshold (i.e. the level at which significant deviation is always presumed) being set at 15%.

Governance capital add-ons would only be imposed if other measures that have been imposed on the undertaking are unlikely to resolve the deficiencies within an appropriate timeframe. The policy issue relates to the length of time which should be regarded as appropriate. CEIOPS proposed a maximum period of 6 months, with supervisory discretion to shorten this period subject to general criteria (option 2). The Commission Services' current view would be to follow this approach.

CEIOPS' final advice proposed allowing a range of methodologies to be used to calculate capital add-ons, since different methodologies may be appropriate in different cases. Harmonised criteria to determine the methodology to be followed for governance capital add-ons are also suggested (option 3). The Commission Services' current view would be to propose a calculation methodology based on supervisors first considering on a notional basis what modifications to the assumptions and parameters underlying the SCR could be made in order that the SCR calculation would better reflect the risk profile of the undertaking. Where modifications to assumptions and parameters would be insufficient or inappropriate for this purpose, alternative methodologies to calculate an SCR which better reflects the undertaking's risk profile may be considered.

**Question 29: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing risk-sensitive harmonised solvency standards;**
- **harmonising supervisory powers, methods and tools; and**
- **introducing proportionate requirements for small undertakings.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

**Question 30: Should supervisors be able to exercise judgment, according to pre-defined criteria, in relation to each of the following:**

- 1) in the case of risk-profile capital add-ons, significant deviations from the SCR that are below 15%**
- 2) for the purposes of determining when a governance capital add-on may be applied, the timeframe to be regarded as appropriate for having allowed other remedial measures to have been exhausted, subject to a maximum period of 6 months**
- 3) the methodology used to determine the capital add-on.**

**(Please provide reasons)**

## **16. Actuarial function**

The actuarial function, which all undertakings must have, is a new requirement under Solvency II. The Solvency II Framework Directive<sup>24</sup> requires the actuarial function to

<sup>24</sup> Articles 47 (1) and (2) of Directive 2009/138/EC



undertake a range of specified tasks. Although some of the responsibilities of the function are specified in the Solvency II Framework Directive, further detail at level 2 is needed to explain how these responsibilities should be carried out to ensure that the function is effective. When further defining the responsibilities of the actuarial function, the following issues need to be addressed:

**A) The standards to be applied by the function:**

Option 1	The function should use technical standards developed by CEIOPS on Level 3
Option 2	The function should rely on technical standards that are widely accepted in the industry and the profession
Option 3	The function should rely on European technical standards to be developed and endorsed by a body of representatives of different stakeholders, including CEIOPS

**B) The scope of the tasks of the actuarial function**

Option 1	It should be left to undertakings to decide on the scope of these tasks individually
Option 2	The general scope of the tasks should be prescribed on Level 2 to some extent

**C) The reporting of the actuarial function**

Option 1	Require annual reporting with definition on Level 2 of its structure and content
Option 2	Require annual reporting but leave the decision on the details up to the undertakings

CEIOPS' final advice concluded that subject to further clarifications on the practical implications, the actuarial function should rely on European actuarial guidelines to be developed and endorsed by a body of representatives of different stakeholders, including CEIOPS (option 3 of A). CEIOPS recommended that the general scope of the tasks should, to some extent, be prescribed in level 2 implementing measures (option 2 of B). CEIOPS also considered it appropriate to require annual reporting, but to leave the decision on the details up to the undertaking (option 2 of C).

The Commission Services' current view would be to largely follow CEIOPS' advice. However, it is proposed that EIOPA should adopt, following a period of public consultation, European actuarial guidelines on technical issues, relating to the tasks of the actuarial function, taking into account the standards set in national and international actuarial associations (this represents a combination of options 2 and 3 of A). Level 2 implementing measures would set out the actuarial function's role in coordinating the calculation of the technical provisions and emphasize the obligation of the actuarial function to contribute to the effective implementation of the risk management system (option 2 of B). The Commission Services propose that the actuarial function should, at least annually, produce a written report to be submitted to the administrative, management or supervisory body. The report should document the tasks that have been undertaken, clearly stating any shortcomings identified and giving recommendations for how the deficiencies could be remedied (option 1 of C).

**Question 31: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:**

- **introducing proportionate requirements for small undertakings;**
- **harmonising supervisory powers, methods and tools;**
- **promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

**(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)**

**Question 32: Do you agree that requiring EIOPA to adopt (non-binding) guidelines at Level 3 would be the most appropriate solution in terms of practicability and level-playing-field considerations? (Please provide reasons)**

**Question 33: Should actuarial guidelines solely relate to technical issues or should they be extended to include professional and ethical guidelines? (Please provide reasons)**

### **17. Supervisory co-operation and co-ordination**

Solvency II aims to make group supervision more effective and efficient, in particular by strengthening cooperation, information exchange and coordination amongst European supervisors. In particular, in the context of group supervision, a number of decisions will have to be taken jointly (by the supervisory authorities concerned), or in consultation with other supervisory authorities, which calls for solid and practical coordination arrangements.

Level 2 implementing measures will need to further specify cooperation and coordination arrangements with respect to the following:

- A. Membership of branches in the college of supervisors
- B. Frequency of college meetings

CEIOPS' final advice on issue A concluded that supervisory authorities of significant branches should be allowed to participate in the college of supervisors on the basis of indicative and non-binding thresholds (option 2). On issue B, CEIOPS concluded that to ensure flexibility and efficiency, the frequency of meetings should be determined in the college work plan and not prescribed in level 2 implementing measures (option 2).

The Commission Services' current view would be to introduce binding quantitative thresholds in order to ensure certainty regarding who should be mandatorily allowed to participate in the college (option 1). On Issue B, the Commission Services would tend to share CEIOPS' view on the need to keep full flexibility for operation of each college (option 2). The Solvency II Framework Directive already requires that colleges should meet at least annually<sup>25</sup>.

The Commission Services' current view is that a minimum set of information, to be systematically exchanged between supervisors, should be set at level 2 in order to ensure an effective exchange of information amongst supervisors. The minimum set envisaged would cover, for both the group and the related undertakings within the group, the SFCR, the Regular Supervisory Report (together with templates) and the main conclusions drawn by supervisors pursuant the supervisory review process.

<sup>25</sup> Article 248 of Directive 2009/138/EC

**Question 34:** Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- harmonising supervisory powers, methods and tools;
- promoting compatibility of prudential supervision of insurance and banking;
- promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA; and
- ensuring efficient supervision of insurance groups and financial conglomerates.

(Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)

**Question 35:** Do you share the view that provisions on colleges should not be set in level 2 implementing measures? (Please provide reasons for your response and, where relevant, suggestions on the provisions which you think should be included at level 2)

**Question 36:** What are your views on the need for supervisors in the college to systematically exchange information? What information would be the most efficient and useful to be exchanged taking into account the potential burden for supervisors?

### **3. Impact on Insurance markets and products**

The Commission will analyse the additional and/ or incremental effects that the policy decisions for the level 2 implementing measures may have on the pricing, design and availability of insurance products and on insurance markets. In order to provide input into this analysis stakeholders are asked to consider the following questions in light of the approach that the Commission Services has suggested taking in relation to each of the level 2 policy issues in section 2. Views are welcomed on whether decisions taken at level 2 may effect the conclusions drawn in the level 1 Impact Assessment Report and on Deloitte's conclusions.

<b>1. Impacts on products</b>
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The level 1 Impact Assessment concluded that an economic risk-based approach would enable undertakings to develop new innovative products and provide benefits for policy holders including potential price reductions and greater product variety flowing from increased competition. Greater confidence in products offered would also arise from improved risk management. Where current pricing of products is not based on sound economic principles, product offerings and prices may be aligned with the true cost of insurance. In the short-term, the need to adapt products may lead to reduced product offerings by undertakings, whose financial requirements are expected to be higher under Solvency II (for example long-term/ high-severity insurance lines). Over the long-term coverage is expected to stabilise as new products emerge, prices are adjusted and insurers make greater use of risk mitigation techniques.

Deloitte's report also concluded that there will be reduced cross-subsidisation and greater product innovation as insurers adopt risk-based pricing and manage capital more in line with underlying risk. Deloitte highlighted that increases in insurance prices would be likely to occur where undertakings have to raise additional capital. In such cases, the extent of price

increases will depend on the market structure. A smaller proportion of the increase in financial requirements is likely to be passed on to consumers in highly competitive markets. Where financial requirements decrease, the extent price decreases will also depend on the market structure. Price decreases are expected to be more likely in competitive markets.

**Question 37: Do you anticipate that the Commission Services' suggested approach for level 2 implementing measures<sup>26</sup> would result in an increase or decrease in insurance prices? (Please provide details of the types of product or groups of policy holders affected, the magnitude of the increase or decrease expected and whether the change results from change in the value of technical provisions or capital requirements)**

**Question 38: Would the Commission Services' suggested approach for level 2 implementing measures result in a reduction of cross-subsidisation between different lines of business or groups of policy holders? (Please provide details of which lines of business or groups of policy holders will be most affected and the reasons for this)**

**Question 39: Would the Commission Services' suggested approach for level 2 implementing measures stimulate product innovation? (Please provide examples of the type of product innovation that is expected and details of the lines of business that this product innovation will relate to)**

**Question 40: Would the Commission Services' suggested approach for level 2 implementing measures result in a withdrawal of certain products from the market? (Please provide reasons and examples of products that may be withdrawn)**

## **2. Impacts on markets**

The level 1 Impact Assessment concluded that Solvency II would contribute to the further integration of the EU insurance market. The alignment of quantitative requirements with economic reality is expected to improve the international competitiveness of EU insurers and reinsurers. Undertakings which diversify across lines of business and risk classes are expected to benefit from lower capital requirements.

Deloitte's report concluded that impacts would be smaller for undertakings whose internal practices are already "risk based supported by economic capital models", this may be more likely for larger, multinational undertakings. Insurers' business models will affect access to capital and the degree of cross-subsidisation across markets or lines of business. More diversified undertakings (geographically or across products) will be better positioned to absorb prices and cross-subsidise than undertakings who only write a few line(s) of business.

**Question 41: Would the Commission Services' suggested approach for level 2 implementing measures promote particular types of insurance business model (e.g. specialisation vs. diversification, joint-stock companies vs. mutuals, branches vs. subsidiaries, groups vs. single legal entities)? (Please provide reasons and examples)**

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<sup>26</sup> References to the 'Commission Services' suggested approach for level 2 implementing measures should be understood to mean the Commission Services' stated current view in relation to each of the 17 policy issues discussed in Section 2.

**Question 42: Would the Commission Services' suggested approach for level 2 implementing measures affect competition across undertakings in the EU and/or the functioning of the internal market? (Please provide reasons and examples)**

**Question 43: What would the impact be of the Commission Services' suggested approach for level 2 implementing measures on small or medium-size enterprises as buyers of insurance? (Please provide examples)**

**Question 44: What impacts would the Commission Services' suggested approach for level 2 implementing measures have on the captive market? (Please provide examples)**

**Question 45: What impacts would the Commission Services' suggested approach for level 2 implementing measures have on third country insurers and reinsurers? (Please provide examples)**

## **4. Social and economic impacts**

The Commission's level 2 impact assessment report will analyse any potential social and economic effects resulting from the choice of policy options at level 2. Views are particularly sought on any indirect effects for consumers and households, for example potential impacts on the financing, organisation or access to health systems. Stakeholders are also invited to provide views on the potential impact in changes in the insurability of certain risks and the potential transfer of risks to policy holders. Finally, we would be interested in stakeholders' views on the potential effects on financial stability, including the impact on capital markets, which the suggested approach for level 2 implementing measures may have. Views are welcomed on whether decisions taken at level 2 may effect the conclusions drawn in the level 1 Impact Assessment Report and on Deloitte's conclusions.

### **1A: Social impacts - general**

The level 1 Impact Assessment acknowledged the important role that private insurance plays in society in complementing the social protection provided by the State. The role of private insurance "depends on the interaction with, and the extent of, the social protection provide by publicly fund systems". This differs considerably from one Member State to another making it more difficult to draw conclusions about the EU-wide impact of Solvency II.

Deloitte's report pointed to several consumer and social benefits that could be realised under Solvency II, including reduced likelihood of failure of an insurer, greater competition between undertakings leading to downward pressure on prices and a better understanding of risk amongst consumers. The realisation of these benefits will depend on whether financial requirements increase under Solvency II. For example, an overall net increase in financial requirements for the whole industry may jeopardize the realisation of these benefits. Policy holders that need to protect physical assets will benefit from anticipated lower prices for mass risk products. Policy holders that need to protect themselves or save and invest may be negatively affected if Solvency II leads to higher financial requirements or more volatile balance sheets for the providers of certain insurance products. This may lead to either higher prices for these products or greater risk-transfer to consumers.

**Question 46: What social, environmental or economic knock-on effects could occur as a result of changes to the design, pricing and availability of insurance products? (Please provide examples)**

**Question 47: Would the Commission Services' suggested approach for level 2 implementing measures<sup>27</sup> make it easier or more difficult to obtain insurance for certain risks or groups of policy holders, and will there be a transfer of risk from insurers to consumers? (Please provide examples and where relevant, details of the risks and/ or groups of policyholders affected)**

**Question 48: Would the Commission Services' suggested approach for level 2 implementing measures have significant consequences for the financial situation of individuals/ households, both immediately and in the long run? (Please provide examples)**

**Question 49: What is the impact on the social inclusion and protection of particular groups? (Please provide examples of the specific groups of individuals affected (e.g. firms, localities, the most vulnerable, the most at risk of poverty, the elderly))**

**Question 50: Would the Commission Services' suggested approach for level 2 implementing measures affect some categories of consumers more than others (e.g. elderly people vs. younger people; low income consumers vs. high income; people collectively insured vs. people individually insured)? (Please provide details of the expected affects and examples)**

## **1B: Social impacts - health**

Private health insurance across Member States can generally be categorised into one of three categories. Firstly, private health insurance that plays a supplementary role to public systems (e.g. UK), secondly private health insurance that plays a substitutive role (e.g. NL) and thirdly private health insurance that plays a complementary role i.e. topping-up state cover (e.g. FR).

Deloitte's report suggested that impacts will be the greatest for Member States where private health insurance plays a substitutive role. Impacts are likely to be the same where private health insurance plays either a complementary or supplementary role. Due to a lack of data, Deloitte was not able to draw conclusions about the specific impacts in all Member States.

**Question 51: What is the impact on the access to, and effects on, social protection and health systems?**

**Question 52: Would the Commission Services' suggested approach for level 2 implementing measures impact more heavily specific types of health insurance products (e.g. disability insurance, long term care insurance)? (Please provide examples of the expected impact)**

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<sup>27</sup> References to the 'Commission Services' suggested approach for level 2 implementing measures should be understood to mean the Commission Services' stated current view in relation to each of the 17 policy issues discussed in Section 2.

**Question 53: Would the Commission Services' suggested approach for level 2 implementing measures have significant effects in certain Member State and/or regions due to the specific role played by the private insurance in those Member States /regions (e.g. primary and complementary health insurance)? (Please provide details of those effects and examples)**

<b>Economic impacts</b>
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The level 1 Impact Assessment concluded that the alignment of regulatory requirements with economic reality will provide for a better allocation of capital at firm level, industry level and within the EU economy as whole. The report also concluded that more efficient allocation of risk and capital will promote financial stability. The importance of insurers as institutional investors was also noted and it was suggested that there may be short-term impacts while insurers adjust their portfolios to take into account the capital requirements stemming from different asset classes. Analysis from the ECB indicated that this re-allocation has already started to occur ahead of Solvency II coming into force.

Deloitte's report also concluded that insurers may rebalance their investment portfolios in response to changing financial requirements and that this may have some transitional impacts on financial markets. Non-financial sectors are likely to be impacted if the financial requirements associated with providing business to business insurance increase. Deloitte considered that the level 2 policy decisions that could affect financial stability are decisions on the discount rates, decisions on the equity risk charge, recognition of geographical diversification in the SCR and recognition of non proportional reinsurance.

**Question 54: What is the impact on specific economic sectors (both financial and non-financial)?**

**Question 55: Would the Commission Services' suggested approach for level 2 implementing measures impact the investment policy of insurers? (Please provide reasons and examples)**

**Question 56: Does it contribute to improving the conditions for investment and for the proper functioning of capital markets? (Please provide reasons and examples)**

**Question 57: Would the Commission Services' suggested approach for level 2 implementing measures contribute to financial stability? (Please provide reasons and examples)**