

# Solvency II Update

## Focus on Implementing Technical Standards

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### INTRODUCTION

There has been much activity recently on Level 2 and Level 3 in anticipation of the implementation of Solvency II on 1 January 2016.

This note summarises a number of notable milestones reached recently, although there remain a number of challenges ahead. This note covers:

- Progress on Delegated Acts
- The recent sets of EIOPA consultations on the Implementing Technical Standards (ITS) and Guidelines (i.e. Level 3)

This note focusses in particular on the ITS and a separate note will provide further detail on the Guidelines

- Consultation paper<sup>1</sup> on setting the risk-free discount rate

### DELEGATED ACTS

In October 2014, the EU Commission suggested the text for Delegated Acts,<sup>2</sup> also known as Implementing Measures. These are Level 2 in the EU's framework for enacting Solvency II. As such, they will be binding on national regulators; it is not anticipated that these would require transposition into local frameworks although, in Ireland's case, this has yet to be decided.

<sup>1</sup> European Insurance and Occupational Pensions Authority (November 2014), Consultation paper on a technical document regarding the risk-free interest rate term structure. Retrieved 16 March 2015 from: [https://eiopa.europa.eu/Publications/Consultations/Consultation\\_RFR\\_Technical\\_Documentation.pdf](https://eiopa.europa.eu/Publications/Consultations/Consultation_RFR_Technical_Documentation.pdf)

<sup>2</sup> European Commission (2014), Commission Delegated Regulation (EU) supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). Retrieved 16 March 2015 from: [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/solvency2/delegated/141010-delegated-act-solvency-2\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/delegated/141010-delegated-act-solvency-2_en.pdf)

Before becoming binding, the Delegated Acts required the approval of both the EU Parliament and EU Council. On 28 November 2014, the EU Council published a press release confirming that it intended not to object to the adoption of the Delegated Acts. In December 2014, the Green Party/European Free Alliance lodged a motion in the European Parliament to object to the Delegated Acts on the basis that the acts deviated from EIOPA's technical advice without justification. The motion was rejected, and on 17 January 2015 the Delegated Acts were published in the Official Journal of the EU.<sup>3</sup>

#### Infrastructure Investments

*The recitals to the Delegated Acts mentioned a possible review before December 2018 of the parameters for long-term infrastructure investments. We understand that members of the Parliament are seeking to lobby for a review of this issue before 2018.*

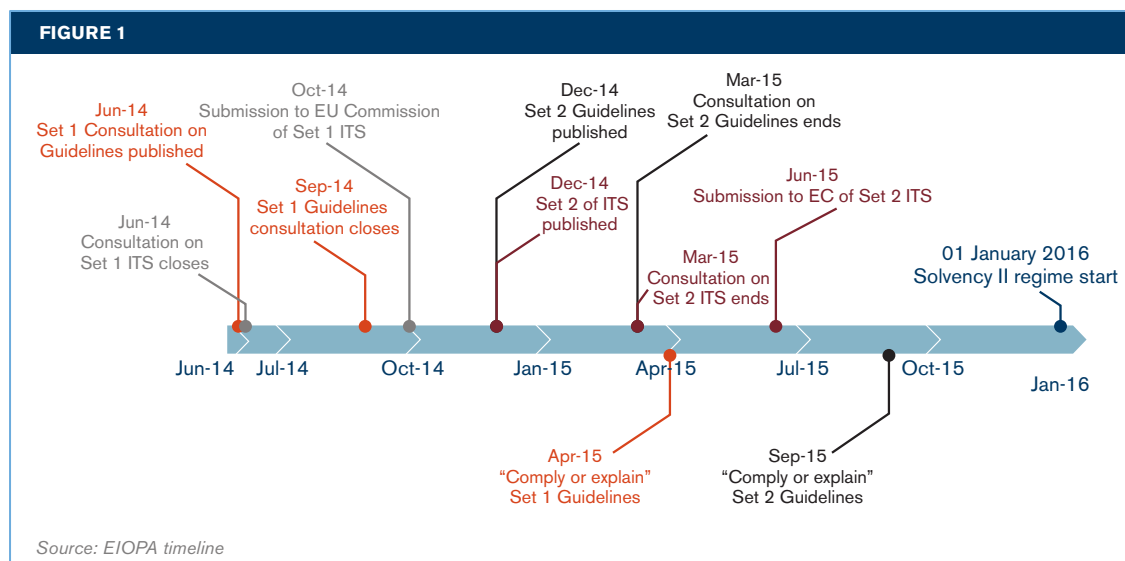
### EIOPA PUBLICATIONS: ITS AND GUIDELINES

EIOPA recently published a number of consultation papers on the ITS and Guidelines.

The ITS are Level 2.5 in the EU's framework for enacting Solvency II—they are drafted by EIOPA and subsequently require adoption by the EU Commission to be enacted.

The Guidelines (Level 3) are also drafted by EIOPA. Once finalised, national regulators do not necessarily need to comply with each guideline; however, each regulator needs to 'comply or explain' if it decides not to comply.

<sup>3</sup> Official Journal of the European Union (January 2015), Legislation. Retrieved 16 March 2015 from: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2015:012:TOC>



The consultation on the first set of ITS and Guidelines is now closed.<sup>4</sup> The second set of each was published in December 2014 and the consultation remains open until March 2015. It is expected that the second set of ITS will be submitted to the European Commission by 30 June 2015. EIOPA's timetable between now and 1 January 2016 is crowded, with many deliveries. This is demonstrated in Figure 1.

In the appendices to this note we have set out a brief summary of the key points arising from each of the ITS. For completeness we have also included a summary of the first set of ITS.

## OTHER EIOPA PUBLICATIONS

### Risk-Free Discount Rate

On 1 November 2014, EIOPA published a technical consultation paper<sup>5</sup> on setting the risk-free discount rate. The consultation period was relatively short, and ended on 21 November 2014. It was a long paper, at 110 pages, with a significant amount of technical content.

There are a few items in the paper which are particularly worthy of comment:

- EIOPA has committed to the use of the Smith-Wilson method for extrapolation of the yield curve beyond the Last Liquid Point (LLP).
- The paper confirms that swaps with LIBOR floating rate will be used as the starting point for determining the yield curve for the sterling, US dollar and Euro. The Bloomberg tickers for the swaps chosen are given.
- The paper confirms the Ultimate Forward Rate (UFR) as 4.2% p.a. for sterling, US dollar and Euro yield curves.
- There is some further information on the calculation of the Volatility Adjustment and Matching Adjustment.
- There is some further information on the data backing the Credit Risk Adjustment, which lowers the yield curve derived from LIBOR swap rates to compensate for the credit risk embedded within LIBOR.
- The proposed asset mix for the volatility adjustment for the UK featured 47.0% fixed interest, which is lower than the Eurozone (86.9%).

### Discount rate consultation

*The consultation paper contained little in the way of surprises in comparison to previous EIOPA specifications of the yield curve (such as the Technical Specification for the Preparatory Phase).*

*There are a number of areas around discount rates where further details would be useful. For example, EIOPA has not published information on the process for updating the UFR assumptions.*

<sup>4</sup> The consultation on the first set of ITS closed on 30 June 2014 whilst the consultation on the first set of guidelines closed on 28 August 2014.

<sup>5</sup> [Op. cit.](#) European Insurance and Occupational Pensions Authority (November 2014), Consultation paper on a technical document.

## APPENDIX I

### ITS – SET 2 OPEN CONSULTATIONS

#### **CP-14-051: Templates and structure of the disclosure of specific information by supervisory authorities**

This ITS concerns the information to be disclosed by Supervisory Authorities and includes annexes setting out the specified information to be provided under the headings of Aggregate Statistical Data (ASD) and the Exercise of Options. A large amount of the ASD will be sourced from the reporting templates submitted by undertakings and groups. In addition to this, the supervisor is required to disclose information on their supervisory activities such as number of inspections, number of internal model reviews and number of corrective measures taken. Interestingly there is specific mention of inspections solely focussed on the reliance on external ratings.

#### **CP-14-052: Templates for the submission of information to the supervisory authorities**

This ITS concerns regulatory reporting. It covers basic information such as reporting currency and frequency of re-submission. There is a lot of information in this consultation, including the draft forms and instructions on the forms.

This paper gives details of the content of individual quantitative reporting templates for the opening information with templates being provided in Annexes to the consultation.

The consultation includes the solo and group quantitative quarterly reporting forms, which cover:

- Balance sheet information (including assets, technical provisions, other liabilities etc.)
- Premium and claim information
- Granular asset information, including CIC code
- Granular information on technical provisions
- Information on own funds
- The MCR (SCR information appears not to be required)

The annual solo and group quantitative information is also outlined in this consultation. Whilst annual reporting includes similar information to the quarterly information, a significant level of additional information is required. This includes:

- Projection of best estimate cash flows
- Additional information on Variable Annuity guarantees and hedging
- Impact of Long Term Guarantee measures, such as the Matching Adjustment, and transitional measures

- Details on the SCR, including for standard formula firms a split into risk categories. These details need to be submitted separately for each ring-fenced fund (including Matching Adjustment portfolios)
- Further details on own funds, including the split into tiers and movement over the reporting period
- Information on assets minus liabilities including split by source
- Further information on reinsurance and SPVs

Firms using an internal model will agree appropriate templates with their regulators.

Firms are expected to resubmit information as soon as possible following a material change from the previous submission. It is not completely clear to us what this means in practice, although it is potentially onerous.

#### **CP-14-053: Capital Add-ons**

This ITS establishes the procedures to be followed by the supervisory authorities when deciding on setting, calculating or removing capital add-ons. One area where capital add-ons may be used is where the assumptions underpinning the SCR do not adequately reflect the firm's risk profile. The regulator is generally expected to notify firms if it intends to apply an add-on, although advance warning is not required.

The regulator may request additional information. If such a request is made, there is no pre-determined timeframe for the response, which is intended to ensure that the timeframe requested by the supervisor is suitable for the nature of the situation.

If the regulator decides to impose an add-on, the information provided to the firm should be suitably detailed to allow the firm to assess the deficiencies and so take steps to eliminate the add-on.

#### **CP-14-054: Risk management: procedures when assessing external credit assessments**

There is little of significance here, as the specified 'procedures' are principle-based and so do not add too much in terms of the detail of how the assessment itself is to be carried out. The risk management policy should address the details of the assessment (e.g. scope, frequency, manner of assessment etc.) and the RMF must assess compliance against this and the use of the results in the technical provisions/SCR. The only item of note is that if the assessment is to be outsourced then it will be classified as a Critical or Important Function or Activity with the associated requirements attached.

#### **CP-14-055: Public disclosure: procedures, formats and templates**

This ITS addresses the Solvency and Financial Condition Report (SFCR) only. It includes the following:

- Details on how to convert assets and liabilities to 'reporting currency'
- Details of which QRTs need to be reported in the SFCR and Group SFCR (refers to the possibility of new templates to assess the effect of the LTG and transitional measures and for non-life claims)
- Requirement for the public disclosure policy to be approved by the board
- Requirements for references in the SFCR to refer directly to the information itself rather than a general document
- Requirements for consistency of information between public disclosure and what is reported to the supervisor
- Details on means of disclosure (e.g. website) for solo firms and Groups
- Details on requirements where subsidiaries are intended to be covered in a single SFCR

#### **CP-14-057: Regional governments and local authorities exposures who are to be treated as exposures to the central government**

This ITS addresses local government exposures, and when for the purposes of Solvency II they may be treated as exposures to the national government, which would result in beneficial treatment in, for example, the spread stress test.

For Ireland, local government exposures may not be treated as exposures to the national government. For the UK, the requirement is quite high and the only equivalent exposures are those to:

- The Scottish Parliament
- The National Assembly for Wales
- The Northern Ireland Assembly

#### **CP-14-058: Equity index for the symmetric adjustment of the equity capital charge**

This ITS sets out the equity indices, and the weighting to be applied to each, in the calculation of the symmetric adjustment (i.e. the equity dampener) for use in the determination of the equity shock.

#### **CP-14-059: Adjusted factors to calculate the capital requirement for currency risk for currencies pegged to the euro**

For currencies which are pegged to the Euro (e.g., Danish Krone, Bulgarian lev, etc.) the 25% factor applicable in the currency risk sub-module can be replaced by a factor, as set out in this ITS, which varies depending on whether one of the local or foreign currencies is the Euro or whether both currencies are pegged to the Euro.

For the avoidance of any doubt, the British Pound cannot be considered to be pegged to the Euro and so no adjustment is permitted.

#### **CP-14-060: Standard deviations in relation to Health Risk Equalisation systems**

This ITS sets some of the parameters for the standard formula SCR in respect of Not Similar to Life Health Insurance which is subject to Dutch health risk equalisation. As such, the parameters may be of limited interest to UK or Irish life insurers.

#### **CP-14-061: Application of the transitional measure for the equity risk sub-module**

This ITS addresses the equity risk sub-module transitional measure under which the equity stress increases linearly from the duration-based equity stress to the full stress amount by the end of the transitional period (seven years). (The Delegated Acts restrict the use of this transitional measure to Type 1 equities only.)

Where a firm wishes to avail of this transitional measure, it must have procedures to identify the assets and to track those exact assets (Type 1 equities written before 1/1/2016). It must properly document this. This information must be available for the Supervisory Authority if requested.

#### **CP-14-062: Recovery plan, finance scheme and supervisory powers in deteriorating financial conditions**

This paper, which is actually a Regulatory Technical Standard (RTS) rather than an ITS, covers the contents of a recovery plan, which must be submitted by a firm when either:

- It fails to comply with its SCR or MCR
- There is a risk of non-compliance in the following three months

Firms are required to submit the recovery plan within one month of non-compliance with the SCR and two months for the MCR. The recovery plan must include:

- Estimate of management expenses
- Estimates of income and expenditure
- A forecast balance sheet (as at the end of the recovery period) and forecast MCR and SCR
- Estimates of the required own funds needed to cover the technical provisions, the SCR and the MCR
- The overall reinsurance policy
- Bases used in estimates provided
- Analysis of the cause of non-compliance
- Remedial actions already taken and planned future remedial actions
- Evidence of approval of the recovery plan by management or the Board and any concerns raised

The ITS gives further details of the approach for each of the points above. The projection should be 'realistic' — this appears to mean that the economic basis may be real world rather than market consistent. It is expected that the quantitative elements of the submission will use regulatory reporting templates.

In deciding if to approve the recovery plan, EIOPA will consider whether the plan is realistic and any pro-cyclical implications of approval. If approval is not granted, the ITS lays out a range of options the regulator may take, which include:

- Requiring the firm to close to new business or restructure its asset portfolio
- Prohibit the disposal of free assets
- Require more regular monitoring and reporting
- Not allow significant decisions to be made without prior regulatory approval

## APPENDIX II

### ITS – SET 1 CLOSED CONSULTATIONS

The first set were submitted by EIOPA to the European Commission on 31 October 2014. The Commission has up to three months to endorse these.

#### **CP-14-004: Procedures to be used for granting supervisory approval for the use of ancillary own-fund items**

This ITS requires that the application for approval for the use of ancillary own-fund items should be made in writing and should be approved by the Board. The application must consist of a cover letter containing certain prescribed confirmations and specified supporting evidence which would allow the supervisory authority to assess whether the application complies with the criteria in Article 90 of the Directive and the related Level 2 text. Rather than simply accepting or rejecting the application, the Supervisory Authority can choose to approve a lower amount than requested by the undertaking.

#### **CP-14-005: Internal Models Approval Processes**

This ITS covers regulatory approval for solo internal model applications. EIOPA has clarified that it will not issue an ITS for group internal model approval; this is instead covered in Delegated Acts.

This ITS covers:

- The contents of the application.
- The assessment of the application. There is a six-month approval period from the date the regulator received the application.
- The right of the firm to withdraw from the approval process.
- The decision on the application, and circumstances under which it may be rejected.
- The transitional plan, which is used when the regulator requires an extension of a partial internal model.
- Following a major change to an internal model, documentary evidence of compliance with the relevant standard is required (i.e. use test, statistical quality test, etc.).
- The process for changes to the model change policy.

#### **CP-14-006: Process to reach a joint decision for group internal models**

This ITS focusses on the need for cooperation between Supervisory Authorities in the approval of group internal models and does not therefore contain anything of direct relevance to undertakings.

#### **CP-14-007: Procedures to be followed for the approval of the application of a matching adjustment**

This ITS covers the procedure regulators must follow in approval of matching adjustment applications. It clarifies that separate applications are required for each portfolio where a matching adjustment will be used. Board approval of the application is required. The application must include:

- Assessment of the assets against the relevant criteria on an asset-by-asset basis
- Assessment of the liabilities against the criteria, including assessment of that the mortality shock does not result in a 5% or greater increase to liabilities
- Assessment of cash flow matching and portfolio management
- Additional content, such as a liquidity plan

In assessing the application, the regulator has 30 days to assess if the application is complete. Following receipt of a complete application, the regulator has six months to complete the assessment. If the firm no longer complies with the matching adjustment criteria, it has two months to remedy the situation to the regulator's satisfaction. If the firm fails to meet this deadline, it cannot re-apply for matching adjustment within the following 24 months.

#### **CP-14-008: ITS on Special Purpose Vehicles**

This ITS covers :

- The conditions and procedures for granting and withdrawing supervisory approval of special purpose vehicles (SPVs)
- The procedures to be followed for cooperation and exchange of information between supervisory authorities, where the SPV is established in one Member State which is not the Member State where the (re)insurance undertaking, from which it assumes risk, is established
- Formats and templates for annual reporting of information for SPVs

Some key points in the detail:

- The SPV must evidence how regulatory requirements are met as well as providing specified supporting documentation in the application. The supervisor has six months to decide on the application.
- The supervisor in the Member State in which the SPV is established must consult with the supervisor in the Member State of transferring risk before authorisation. It must also provide relevant ongoing information including the annual report.
- Qualitative content of the annual report is outlined as well as six templates for the quantitative information.



### CP-14-009: Supervisory approval procedure to use undertaking-specific parameters

This ITS covers the information that firms need to submit to the supervisory authority in the firm's application to use USPs. This includes:

- The date use of the USP is requested.
- The subset of parameters to be replaced by USP.
- Which of the standardised methods have been used to determine the USP value.
- The calculation of the USP.
- Confirmation that the data used complies with Article 203 of the Implementing Measures in meeting data quality requirements.
- Justification of the chosen standardised method to calculate the USP — this is to ensure that the firm has not 'cherry-picked' the method that results in a lower SCR, i.e. the choice is based on the risk profile of the firm (hence the firm must compare all available standardised methods). Justification for excluding any segments where application for USP is not being sought.

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