



Brussels, **XXX**
[...](2014) **XXX** draft

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

IMPACT ASSESSMENT REPORT

Accompanying the proposal for

COMMISSION DELEGATED REGULATION (EU)

Supplementing directive 2009/138/EU of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

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Executive Summary Sheet
Impact assessment on the Solvency II Delegated Acts
A. Need for action
Why? What is the problem being addressed?
<p>This impact assessment covers the Delegated Acts of the Solvency II Directive, which are intended to specify technical aspects on the basis of a total of 76 empowerments in the Directive. The first three specific problems being addressed are common with those set out for the Directive: low risk sensitivity of the existing prudential regime (not accurately reflecting the true financial state of insurers); lack of transparency (more precisely, lack of harmonisation of Member States' transparency rules); and fragmented supervisory requirements. The fourth specific problem is new and has arisen out of the financial crisis: it is an insufficient appetite for long-term investments among insurers.</p>
What is this initiative expected to achieve?
<p>The first two general objectives are common with those set out for the Directive: to enhance policyholder protection and to deepen the integration of the EU insurance market. One new general objective has been added: to foster growth and recovery in Europe.</p>
What is the value added of action at the EU level?
<p>The Solvency II Directive replaces and improves 14 existing insurance Directives, and introduces economic risk-based solvency requirements across all EU Member States for the first time. The issue of subsidiarity was covered in the impact assessment for the Directive, which imposes maximum harmonisation. There is no choice on this matter in the Delegated Acts – the 76 empowerments almost all specify that the Commission <i>shall</i> adopt Delegated Acts in the given area.</p>
B. Solutions
What legislative and non-legislative policy options have been considered? Is there a preferred choice or not? Why?
<p>The impact assessment was carried out for those measures for which significant impacts are to be expected and where the Solvency II Directive allows the Commission a genuine choice of options. Options are considered for the treatment of long-term investments, which vary in the degree of granularity of the capital risk-weights applied. The preferred option provides for the most risk-sensitive formula, allowing for statistically-justified lower capital requirements if insurers pick long-term, high quality assets and, for equities, capital requirements that are suitably counter-cyclical. Options are considered on the quality of the capital held by insurers (their 'own funds') The preferred option enhances the ladder of supervisory intervention without requiring healthy insurers to raise additional capital. Options are also considered on the soundness and transparency of remuneration practices, valuation standards and requirements on supervisory reporting. The preferred options in these areas are selected to strike a balance between harmonisation and proportionality.</p>
Who supports which option?
<p>The Delegated Acts are the result of an extensive consultation process which started in 2009. The European Insurance and Occupational Pensions Authority submitted 4000 pages of advice incorporating the feedback of stakeholders in public consultations. The Commission also held more than 20 meetings of the Expert Group on Banking, Payments and Insurance, consisting of representatives from Member States and with the European Parliament as observer. The version proposed for adoption is therefore consensual. The treatment of long-term investments is also based on the stakeholders' feedback in response to the Commission Green Paper on the long-term financing of the European economy¹ and was already announced in the subsequent Communication². In particular, the initiative to define and foster high-quality securitisation has received strong support</p>

¹ COM(2013)150, 25 March 2013

² COM(2014)168, 27 March 2014

from the Bank of England and the European Central Bank.

C. Impacts of the preferred option

What are the benefits of the preferred option (if any, otherwise main ones)?

The benefits, while accruing partly to insurance undertakings in terms of the reduced likelihood of failure, also impact society more widely. Consumers of insurance products will benefit from stable and secure insurance undertakings capable of meeting their commitments, as a result of all the measures considered herein. With respect to undertakings, the calibrations on capital requirements for assets are designed to achieve a more efficient allocation of capital and greater returns and the disclosure of the principles of the remuneration policy will impose market discipline, avoiding excessive risk taking. Regarding insurance undertakings which are SMEs, the possibility for insurers to use accounting standards other than IFRS is an important proportionality element. Businesses in general – and SMEs in particular – that are potential beneficiaries of investment from insurers will benefit from easier access to funding, stimulating growth in Europe.

What are the costs of the preferred option (if any, otherwise main ones)?

The benefits outlined above considerably outweigh the costs, which fall almost entirely on insurance undertakings and arise essentially from two policy options: the supervisory reporting requirements (mitigated by the power given by the Directive to supervisors to alleviate regular reporting for SME insurers), and the requirement on the quality of own funds going beyond the minimum imposed in the Directive, although this will not force any healthy insurer to raise capital because of these requirements as the average share of Tier 1 capital is well above the proposed limit. The cost of the new requirement for insurers with weaker capital positions will be mitigated by the phasing-in of the quality requirements over 10 years, according to the Directive.

How will businesses, SMEs and micro-enterprises be affected?

SMEs in the general economy (ie. those that are not insurers) will largely benefit from greater access to funding by insurers. This stems from the more favourable treatment, in insurers' capital requirements, of investments in venture capital and private equity funds or debt instruments guaranteed by the European Investment Bank and European Investment Fund, and in high-quality securitisation (including SME loans).

Will there be other significant impacts on national budgets and administrations?

There will be no significant impact on EU or MS budgets.

Will there be other significant impacts?

The measures considered in this impact assessment have only marginal and indirect effects on third countries (via EU subsidiaries of third country insurers for example, or conversely). However the issue of criteria for equivalence of third country regimes is not covered in this impact assessment given that the margin for the exercise of discretion by the Commission in the Delegated Acts was too limited.

D. Follow up

When will the policy be reviewed?

The Delegated Acts include a review clause by 31.12.2018, focusing in particular on the design and calibration of the standard formula for capital requirements, in particular on long-term infrastructure investments and non-life underwriting risks.

1. INTRODUCTION

The subject of this impact assessment report is the Delegated Acts of the Solvency II directive³, which are intended to further specify a range of aspects of the Solvency II Directive in view of its consistent implementation throughout the Union. As not all of these measures are expected to have significant impacts over and above those already arising from the Solvency II directive, specific attention is given to those measures for which significant impacts are to be expected and where the Solvency II Directive allows the Commission a genuine choice of options. For all others a description is provided in Annex 2. Section 5 provides more explanations on the selection of options covered in the report.

1.1. Solvency II

Solvency II is a framework for the taking-up of business and supervision of insurance and reinsurance⁴ undertakings in the Union. The Directive⁵ replaces 14 existing directives (commonly referred to as Solvency I) and provides for a maximum harmonising regime achieving cross-border consistency. It is consistent with other financial service legislation, in particular with the framework for banking supervision (CRD IV/CRR)⁶. Like CRD IV, Solvency II is based on 3 pillars:

Pillar 1: Harmonised valuation and capital requirements

Pillar 2: Harmonised governance, internal control and risk management requirements

Pillar 3: Harmonised supervisory reporting and public disclosure

Solvency II introduces economic risk-based solvency requirements across all EU Member States for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a crude "one-model-fits-all" way of estimating capital requirements to more entity-specific requirements. It also puts a greater focus on risks and their management, as well as introducing stricter rules on the disclosure of certain information publicly.

The Solvency II project was conceived between 2002 and 2007 in times of global growth and financial stability. The Solvency II directive was adopted in November 2009, at a time when the global economy had just suffered a severe shock and was not yet recovering from a financial crisis. Whilst the crisis reinforced the need for Solvency II, given the emphasis that the regime places on good risk management and sound governance, it also made it apparent that the framework would need to be amended with transitional and countercyclical measures to preserve the financial stability of the insurance sector. The vehicle for these amendments was the Omnibus II Directive⁷ that was brought forward by the Commission in January 2011. It took nearly three years of negotiations until a carefully balanced package of several measures was agreed by trilogue parties in November 2013, in particular a package of

³ Directive 2009/138/EC of the Council and the European Parliament

⁴ For the sake of simplicity, all references to "insurance undertakings" or "insurers" in this impact assessment are to be understood as referring to "reinsurance undertakings" as well.

⁵ Hereafter, "the Directive" is understood to mean the Solvency II Directive (2009/138/EC) as modified by the Omnibus II Directive (2014/51/EU)

⁶ Directive 2013/36/EU (hereafter called CRD IV) and (EU) No Regulation 575/2013 (hereafter called CRR).

⁷ Directive 2014/51/EU

measures to assist insurers to continue to provide insurance products with long-term guarantees. In between, the application date for Solvency II needed to be postponed twice⁸ and was finally set to January 2016, more than three years after the originally set application date of November 2012.

In order to provide to firms and supervisors the legal framework required to meet several application deadlines for elements requiring supervisory approval under Solvency II (such as internal models), the Delegated Acts will need to be in force by March 2015 the latest. Taking into account the three plus three month objection period for the Council and the European Parliament, the Commission will need to adopt its proposal by September 2014 at the very latest. Otherwise there is a risk that insurers and supervisors will not have sufficient time to be ready in time for the 1 January 2016 application date of Solvency II.

1.2. The Delegated Acts

Much material that was originally designated for the Delegated Acts has now been included in the Directive via the Omnibus II Directive by the Council and Parliament. The Directive fixes sensitive policy issues to the greatest extent possible, in particular with regards to market consistent valuation of the prudential balance sheet, the treatment of products with long-term guarantees, the design and level of capital requirements and the treatment of insurance groups.⁹

The proposed Delegated Acts, which run almost 330 pages excluding annexes, are based on a total of 76 empowerments¹⁰. Issues for Delegated Acts are mainly connected to the operationalisation of the Directive. For the major part these concern technical topics, like the choice of standardised calculation methods for specific parameters, or the specific features that determine the classification of own funds items.

This impact assessment will not discuss elements in the Delegated Acts with limited scope or political impact, or elements that have been consensual for a long time (see the long in-depth, consultation process described in section 2). Instead, the impact assessment rather concentrates on the decisions remaining for the Delegated Acts with significant impact, and scope for Commission choice. In particular, these concern capital requirements and other measures relating to long term investments, requirements on the composition of insurers' own funds, remuneration issues, requirements for valuation of assets and liabilities, and reporting. The choice of the policy options covered in this impact assessment is presented in more details as an introduction to section 5 and in Annex 2.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Procedural issues

The Steering Group for this impact assessment was formed by representatives of DG MARKT, DG ENTR, DG ECFIN, DG COMP, DG SANCO, DG EMPL, DG R&D, Secretariat General, Legal Service and the Joint Research Centre. The Group was created in 2008. It met on 8 September 2008, 1 October 2009, 9 October 2010, 26 June 2012 and 25

⁸ By Directive 2012/23/EU (so called first 'Quick Fix') and Directive 2013/58/EU (so called second 'Quick Fix').

⁹ See Annex 1 for an overview of the Solvency II Directive as amended by Omnibus II.

¹⁰ For a complete overview of empowerments see Annex 2. Some of these empowerments may subsequently be replaced by Regulatory Technical Standards prepared by EIOPA, according to the "sunrise clause" in Article 301b of the Solvency II Directive.

February 2014. The long intervals between the meetings are illustrative of the length and complexity of the Delegated Acts and the duration of the negotiating process of the Omnibus II Directive. The Impact Assessment board gave a first opinion on 11 April 2014, and a final opinion on 21 May 2014.

2.2. External expertise, preparatory work and consultation of interested parties

2.2.1. Quantitative impact studies and consultations carried out by EIOPA and the Commission

Between 2005 and 2013, the development of Solvency II has involved six Quantitative Impact Studies carried out by the European Insurance and Occupational Pensions Authority (EIOPA)¹¹. Of these, the fourth and the fifth (QIS4 and QIS5) in particular aimed to inform policy choices in relation to the detailed rules to be set down in the Delegated Acts, whereas the others elucidated choices for the Directive and for Omnibus II¹².

In terms of market share, 60% of insurers and reinsurers that will be subject to Solvency II (1,412 individual companies and 111 groups from 16 EEA countries plus Switzerland) participated in QIS4. The participation rate increased further in QIS5 (68%, 2520 individual undertakings, 167 groups) with notably many small and medium sized undertakings participating. The technical specifications for this study anticipated the quantitative content of the Delegated Acts to a large extent; it was subject to a five week consultation, which resulted in several changes being made to the tested specifications, which fed into the draft delegated acts.¹³ The QIS5 results showed that the insurance industry was at the time well-positioned to meet the new solvency requirements. Overall the participating companies had €395bn of surplus capital that was not required to meet prudential purposes.¹⁴

The QIS5 results do, however, to a large extent pre-date the sovereign debt crisis that affected long-term guarantee business and was instrumental for the introduction of additional countercyclical and transitional measures (see chapter 3.1.2 for more details). Therefore, an additional impact analysis was carried out by EIOPA (Long-Term Guarantee Assessment or LTGA) in order to supplement the QIS5 results. It was requested by the Council Parliament and Commission in 2012 (and completed in June 2013) in order to facilitate an agreement on the Omnibus II Directive¹⁵. In its final report on the LTGA in June 2013¹⁶, EIOPA recommended that a certain set of measure should be included in the Solvency II framework. These recommendations were welcomed¹⁷ and taken up by the Commission¹⁸.

¹¹ References to EIOPA throughout this document should be taken to refer to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), the predecessor organisation of EIOPA, for work completed before 1 January 2011 and to EIOPA thereafter.

¹² The sixth study was the Long Term Guarantee Assessment (LTGA) referred to later in this section.

¹³ A summary of the main changes was included in the letter from Deputy Director General D. Wright to EIOPA Chairman Gabriel Bernardino, dated 5 July 2010

http://ec.europa.eu/internal_market/insurance/docs/solvency/qis5/201007/dw_letter_en.pdf

¹⁴ EIOPA Report on the fifth Quantitative Impact Study (QIS5) for Solvency II

¹⁵ Letter from Director General J. Faull to EIOPA Chairman G. Bernardino dated 19 December 2012, http://ec.europa.eu/internal_market/insurance/docs/solvency/20121219_letter-faull-bernardino_en.pdf

¹⁶ Technical Findings on the long-term guarantees assessment (EIOPA, June 2013):

https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/QIS/Preparatory_forthcoming_assessments/final/outcome/EIOPA_LTGA_Report_14_June_2013_01.pdf

¹⁷ COM Press release IP/13/547 dated 14 June 2013, http://europa.eu/rapid/press-release_IP-13-547_en.htm

¹⁸ To the major part the measures have been introduced in the Directive using Omnibus II, with only few remaining technical detail that has been taken up in the Delegated Acts.

The Delegated Acts are also based on more than 4000 pages of technical advice provided by EIOPA in 2009 and 2010. A formal Call for Advice was sent in March 2009¹⁹, once the Directive and the scope of the empowerment provisions had been politically agreed. The EIOPA advice, which was subject to public consultation²⁰, was provided to the Commission between November 2009 and January 2010.

The technical advice provided by EIOPA in 2009 and 2010 has been followed, apart from some areas where new input was received subsequently (as described in Annex 2). In particular regarding the calibration of capital requirements on long-term investments, taking into account the views of and empirical evidence provided by other stakeholders, including Member States, organizations protecting consumers' interests and the European insurance industry including mutuals.

After receiving EIOPA's advice between 2009 and 2010, which was itself publicly consulted, the Commission carried out its own public consultation for more than 8 weeks between November 2010 and January 2011²¹. 68 responses were received from stakeholders, including actuaries, citizens, industry representatives, national and European interests groups and public authorities. The main comments related to the concerns of stakeholders on the impact on long-term insurance products, volatility and pro-cyclicality, proportionality, limiting the reporting burden and the need for transitional measures²². Most of these issues were solved in the Directive by amendments introduced by Omnibus II²³.

In addition, the insurance and reinsurance industry was a key contributor to the Commission Green Paper on the long-term financing of the European economy²⁴ in spring 2013. In parallel, EIOPA, mandated by the Commission in September 2012²⁵, launched a public consultation on its report on the calibration and design of capital requirements for long-term investments, eventually adopted in December 2013²⁶. The draft Delegated Acts contribute to the implementation of the policy actions stemming from these consultations, as set out in the Commission Communication on long-term financing of the European economy, of March 2014²⁷ (see **section 4.3.1** for more details).

2.2.2. *Other studies: Deloitte and Joint Research Centre*

In June 2009, the European Commission engaged the consultant Deloitte to undertake an independent analysis of the impacts of different options in respect of the issues for the Delegated Acts identified by EIOPA and the Commission. Deloitte carried a public

¹⁹ Call for Advice from EIOPA (EIOPA' contribution to the impact assessment of the Level 2 implementing measures for Solvency II)

http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/call_for_advice_from_EIOPA_en.pdf

²⁰ EIOPA advice was produced in three waves – the first wave of consultations took place between 1 April 2009 and 8 June 2009, the second wave of consultations took place between 2 July 2009 and 11 September 2009 and the final wave of consultations took place between 2 November 2009 and 11 December 2009.

²¹ http://ec.europa.eu/internal_market/consultations/2010/solvency-2_en.htm

²² Summary of Responses to the Consultation on the Level 2 implementing measures for Solvency II available at http://ec.europa.eu/internal_market/consultations/docs/2010/solvency-2/feedback_summary_en.pdf

²³ See Annex 1 for a description of the Directive, including Omnibus II amendments (in particular the long-term guarantees measures).

²⁴ COM(2013)150, 25 March 2013

²⁵ Letter from Director General J. Faull to EIOPA Chairman G. Bernardino dated 26 September 2013, http://ec.europa.eu/internal_market/insurance/docs/solvency/20120926-letter-faull_en.pdf

²⁶ EIOPA technical report on the Standard formula design and calibration for certain long-term investments, http://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments_2_.pdf

²⁷ COM(2014)168 final, adopted on 27 March 2014

consultation²⁸ mid-way through its study, allowing stakeholders to comment on its initial conclusions. The feedback from this consultation was used to substantiate a number of the conclusions in the final report. The final report was submitted to the Commission in October 2010 and is attached as an annex to this impact assessment.

The Deloitte study provides useful insights on the impacts of the different policy options. However, it was based on methodology and data tested in QIS4, which was carried out in 2008 and based on insurers' financial positions at the year-end 2007. Therefore, the Commission considers that for issues relating to quantitative requirements, Deloitte's conclusions (in particular those pertaining to the issue of balance sheet volatility) must be reconsidered in the light of the subsequent QIS5 and LTGA results, and eventually in light of the long-term guarantees measures introduced by Omnibus II.

When considering the impact assessment for the Directive, the Impact Assessment Board identified a small number of areas where the analysis undertaken needed further elaboration in the Delegated Acts. The Commission mandated Deloitte to examine each of these areas in detail. In particular, Deloitte was asked to analyse the administrative burden of the reporting requirements under Solvency II using the European Standard Cost Model (see section 5.6).

Useful contributions have also been received from other parties. For example, the Joint Research Centre of the Commission developed a quantitative model to assess the macroeconomic impact of Solvency II. This analysis was mandated by the Commission to feed into the contribution of DG ECFIN²⁹ in the impact assessment study for the Commission's Solvency II proposal in 2007.

2.3. Consultations on the text of the draft delegated acts

Since October 2009, the Commission has held more than 20 meetings of the relevant expert group³⁰, during which the draft Delegated Acts were discussed among experts from the finance ministries and supervisory authorities of Member States and EIOPA. The European Parliament was also invited to send a representative. Stakeholder organisations representing the views of the European insurance industry, including Insurance Europe, the Association of Mutual Insurers and Insurance Cooperatives in Europe (AMICE), the Chief Risk Officers' Forum (CRO Forum) and Chief Financial Officers' Forum (CFO Forum) and the Actuarial Organisation of Europe³¹ also had numerous opportunities to comment on the different drafts. In addition, the European Commission has sought the views of consumers via the Financial Services Users Group (FSUG)³².

The Commission also hosted a Public Hearing³³ on the draft Delegated Acts on 4 May 2010. The public hearing was attended by over 320 people from undertakings, supervisory authorities and consumer groups. The main issues raised related to capital requirements, the need for proportionate requirements for SMEs particularly in the area of reporting, and the need to create the right investment incentives for insurers.

²⁸ The Deloitte consultation ran for one month between 19 January 2010 and 19 February 2010.

²⁹ DG ECFIN study: http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/annex-c06_en.pdf

³⁰ The expert group was the EIOPC (Expert group on Insurance and Occupational Pensions) which was replaced in 2011 by the EGBPI (Expert group on Banking, Payments and Insurance).

³¹ Formerly called the Groupe Consultatif Actuariel Européen

³² Presentations to the FSUG were given in December 2009, January 2011 and October 2011. Drafts of the Delegated Acts were shared with FSUG representatives in March 2010 and November 2010.

³³ May 2010: Public Hearing on Level 2 implementing measures for Solvency Panel Summary http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/hearing052010/panel_summary.pdf

Following the political agreement on Omnibus II, two additional meetings of the expert group were held to discuss updated draft delegated acts, on 28 January 2014 and 26 March 2014, which confirmed a broad consensus.

3. POLICY CONTEXT, PROBLEM DEFINITION AND SUBSIDIARITY

3.1. Market context

3.1.1. General context

The European insurance market is the largest in the world, making up around 33%³⁴ of the total premiums written globally in 2012³⁵. The second and third largest markets are North America and Asia, which are very similar in size with 30% and 29% of global premiums respectively. Total European gross written premiums amounted to more than €1 100bn in 2012.

More than 5 300 insurance companies³⁶ were operating in Europe in 2012. The majority were joint stock companies and mutual insurers, but they can also be public institutions, cooperatives, etc. The European insurance industry employs more than 930 000 people directly. There are also around 1 million outsourced employees and intermediaries.

The insurance sector has the largest pool of investments in the European Union, with almost €8 400bn invested in the global economy in 2012. This is equal to 58% of the GDP of the EU. The insurance sector is a key source of the investment needed to support growth in the economy and it is the largest institutional investor in Europe, with more than 50% of all European institutional assets under management in 2011.³⁷ More detailed information about EU insurers' investment portfolio is laid down in Annex 3.

3.1.2. Issues connected to the current market environment

There are two principal issues faced by insurers in current market conditions:

- the low interest rate environment, which makes it more difficult for insurers to obtain sufficient investment yields, especially with a view to meeting financial guarantees that they have offered in the past. As a consequence insurers may be more inclined to seek higher yields by adapting their investment strategies particularly where this is necessary to meet onerous in-force guarantees (evidence of a "hunt for yield", discussed in section 3.3.1).

³⁴ This includes central and eastern Europe and therefore includes Russia and the Ukraine, which together account for around 1% of global premiums

³⁵ 'European Insurance – Key Facts', Insurance Europe (30 August 2013) and Swiss Re "World insurance in 2012" (Sigma No. 3/2013)

³⁶ Not including the small regional German insurance associations, France's "mutuelles" regulated under Code de la Mutualité, Belgium's "mutuelles" and Spain's regionally supervised insurers.

³⁷ Banks had lending assets of approximately €46trn but are not considered institutional investors. The OECD statistical yearbook identifies institutional investors as pension funds, insurance companies and investment companies, such as sovereign wealth funds.

- the volatility of asset prices. Insurers mostly hold debt instruments to meet their long-term obligations. As seen throughout the financial crisis the value of these instruments can be very volatile, stemming both from changes in the expectation of default and from changes in the overall levels of liquidity and demand in the debt markets. However, the long-term cash-flow based investment strategy of long-term insurers means they are less reliant on short-term price movements in their assets where these are unrelated to default.

These problems have to be considered against the background that Solvency II is founded on the principle that assets and liabilities must be valued on a market consistent basis. A certain degree of volatility is unavoidable in a market consistent framework and is desirable for a risk-based regime since it provides an indicator that the economic situation or the risk profile of the insurer is changing. One of the main problems with Solvency I³⁸ was indeed that its lack of risk-sensitivity did not incentivise insurers to effectively manage risk.

However, while market consistent valuation must ensure that the regime is risk-sensitive, it should not create artificial volatility (that is, volatility which does not correspond to changes in the economic situation or the insurers' risk-profile).

The long-term guarantees measures incorporated in the Directive by Omnibus II³⁹, which constitute an essential background for understanding the Delegated Acts, reduce short-term balance sheet volatility stemming from short-term market movements. What remains for the delegated acts to address is the calibration capital requirements on investments, which must cater for the new investment strategies adopted by insurers in the current low interest rate environment, without creating additional risks. This is connected to the Commission's long-term investment agenda (see sections 4.1.1 and 4.2.1).

3.2. The current legislative framework

The rationale for EU insurance legislation is to facilitate the development of a Single Market in insurance services, whilst at the same time securing an adequate level of consumer protection. The development of the necessary legislative framework began in the 1970s with the first generation Insurance Directives⁴⁰, but was only completed in the early 1990s with the third generation Insurance Directives. The third generation Insurance Directives established an "EU passport" (single licence) for insurers based on the concept of minimum harmonisation and mutual recognition.

However, Solvency I, contained a number of structural weaknesses. In particular, the regime was not risk sensitive, and a number of key risks, including market, credit and operational risk were either not captured at all in the required solvency margin or not properly taken into account. As a result, the Solvency I regime did not offer an optimum level of policyholder protection. Many Member States have also concluded that the EU minimum requirements

³⁸ Hereafter, "Solvency I" is used as a general term to refer to the set of 14 directives currently applicable in the insurance and reinsurance sector, which will be replaced by the Solvency II directive on 1.1.2016 (see section 3.2 on the current legislative framework).

³⁹ See Annex 1 for a description of the measures incorporated in the Directive.

⁴⁰ First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance; First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance; Council Directive 73/240/EEC of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance.

were not enough, and have undertaken their own reforms. This has led to a divergent array of existing regimes, hampering the goal of a single market.

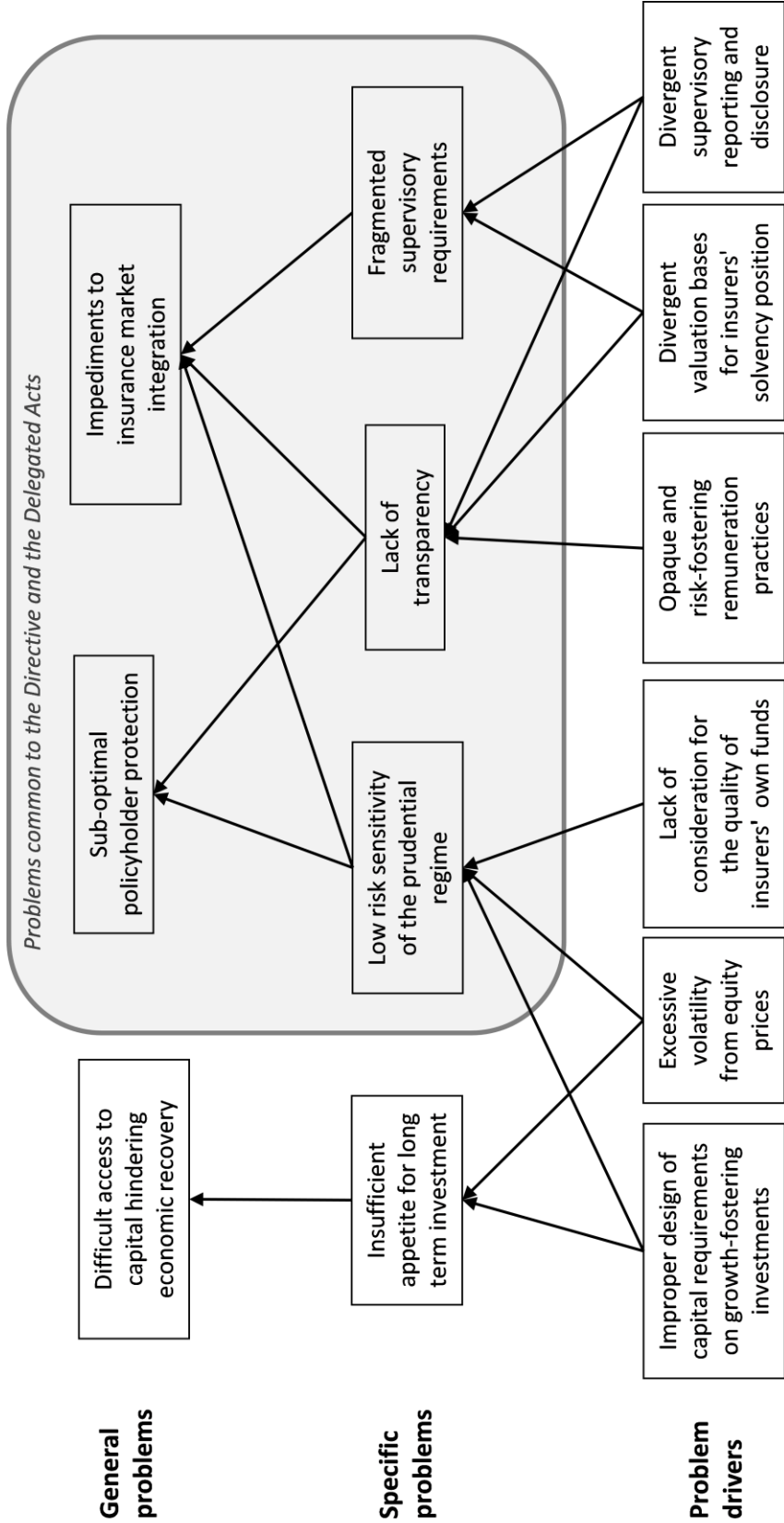
The Solvency II Directive was adopted in November 2009⁴¹. It replaces 14 existing insurance Directives including Life, Non-life, Reinsurance, Insurance Groups and Winding-up Directives. In 2014 and 2015 steps are already being taken toward the implementation of Solvency II through the application of EIOPA's Guidelines for the Preparation of Solvency II⁴². The Guidelines foresee a gradual application through 'phasing-in' provisions, which set out different expectations for 2014 and 2015. They cover a number of key areas of Solvency II, focussing on pillars II and III: system of governance, including risk management; forward looking assessment of the undertaking's own risk (based on the Own Risk and Solvency Assessment (ORSA) principles); submission of information to supervisors; pre-application for internal models. The quantitative solvency requirements set out under pillar 1 will only be introduced with the application of Solvency II on 1 January 2016.

⁴¹ See Annex 1 for further details about the Directive

⁴² Adopted by EIOPA on 31 October 2013, <https://eiopa.europa.eu/en/publications/eiopa-guidelines/index.html>

3.3. Problem definition

Figure 1: Problem tree



3.3.1. Specific problems

Insufficient appetite for long-term investments

European insurers are the largest investors in Europe's financial markets, holding €8.4trn assets⁴³ as of the end of 2012. But investment is not an end *per se* in the insurance business. The primary business of insurers is to provide protection to policyholders. Investment, and provision of long-term financing in particular, is a by-product of this activity, as insurers invest the premiums in such a way as to honour their promises to policyholders.

At present, one can observe that insurers have so far invested only a very small share of their portfolio in asset classes that the Commission considers as essential to the financing of the EU economy (see section 4.2.1). According to a survey by Insurance Europe⁴⁴, the thirteen largest insurance groups, holding €3trn assets, only held at the end of 2011 €53bn in securitisation, €12bn in infrastructure, €14bn in direct SME loans and €19 bn in private equity.

A number of recent news and surveys can shed lights on insurers' intentions in the future regarding asset allocation, and there are mixed signals. For example, the European Venture Capital Association (EVCA) estimates that 30% of insurers have put their private equity/venture capital investment programme on hold, while waiting to see what the equity calibrations will be for Solvency II⁴⁵. On the other hand, a Blackrock survey concluded that 32% of insurers would increase their investment into private equity under Solvency II⁴⁶. More generally, an ING survey⁴⁷ concluded that insurers' need to counteract falling investment returns in a low interest rate environment is fuelling a degree of re-risking, with insurer's investments into equity or infrastructure likely to increase significantly over the coming years, at the expense of investments in sovereign debt for example. "*[Under Solvency II] insurers don't get a charge for illiquid assets, but these assets have a higher return. We see an enormous increase in interest*" a former director of ING's insurance arm told the Financial Times⁴⁸. This trend is confirmed by a recent study by Standard & Poor on infrastructure⁴⁹ and various announcements by large insurance companies⁵⁰. This "hunt for yield" is also closely monitored by supervisors, as evidenced in EIOPA's Financial Stability reports⁵¹ since the first-half of 2013, as well as in reports on risks and vulnerabilities in the EU's financial system, published by the Joint Committee of the European Supervisory Authorities⁵².

⁴³ 'European Insurance – Key Facts', Insurance Europe, 30 August 2013.

⁴⁴ "Funding the future: insurers' role as institutional investors", Insurance Europe & Oliver Wyman, June 2013 (pp 16, 24 to 26)

⁴⁵ http://www.evca.eu/uploadedfiles/EVCA_response_EIOPA_discussion_paper.pdf, p.9 survey covering 19 insurers (May 2013)

⁴⁶ BlackRock 'Balancing risk, return and capital requirements – The effect of Solvency II on Asset Allocation and Investment Strategy', page 12 (February 2012)

⁴⁷ http://www.ingim.com/EU/News/News/IWP_072400 - survey covering 190 fund managers (March 2013); two-thirds of fund managers said insurers will increase their equity allocations over the next five years, with only 8 per cent anticipating a cut. Besides, 49% say insurers have increased their exposure to 'new' asset classes such as infrastructure over the past 12 months, and 77% expect this to increase.

⁴⁸ Financial Times, "Insurers' hunt for yield begins" (3 April 2013)

⁴⁹ " *Institutional investors are becoming increasingly attracted to infrastructure, due to their need to match long-term assets and liabilities [...] Six large insurers have said they will invest £25 billion (\$40.9 billion) in the British government's National Infrastructure Plan, which plans to pump £375 billion into energy, transportation, and waste and water projects in the next five years and beyond.*" (S&P, Global Infrastructure: how to fill a \$500 billion hole, January 2014)

⁵⁰ For example, Allianz's CFO announced that it would increase the group's exposure to alternative investments such as private equity, infrastructure and real estate from €50bn to €88bn (Oddo equity research, Insurance daily, 14 October 2013).

⁵¹ <https://eiopa.europa.eu/en/publications/financial-stability/eiopa-financial-stability-reports/index.html>

⁵² <https://eiopa.europa.eu/en/joint-committee/index.html>

It is crucial that prudential regulation should not unduly restrain insurers' appetite for long-term investments, while properly capturing the risks. Even though investment decisions may be driven by many different factors (e.g. insurers' risk appetite or expertise, accounting rules, taxes, etc.), the driver in the Solvency II Delegated Acts on which the Commission has announced it would act in is the design and calibration of capital requirements. Consequences on insurers' investment behaviour will be monitored (using insurers' reporting to supervisors, for example on the composition of their investment portfolio, see section 5.6). In addition the Delegated Acts include a review clause allowing to adjust the capital requirements if needed.

Low risk sensitivity of the prudential regime

The capital requirements set out by Solvency I were not forward-looking and a number of risks, including market, credit and operational risk⁵³, were not adequately captured. As a result, Solvency I did not accurately reflect the true financial state of insurers and reinsurers, did not focus on the actual drivers of insolvency and did not give the right incentives to insurers to manage risks. As noted in the Level 1 impact assessment EIOPA's survey on failed insurers and 'near-misses' from 2005⁵⁴ confirmed that in more than 75% of the cases examined, the reported solvency ratio up to one year before failure was more than 100%, and in 20% of the cases, the reported ratio was over 200%. This shows that the Solvency I requirements do not provide sufficient early warning for an intervention to be launched. This lack of risk sensitivity does not facilitate optimal allocation of capital, not only across the insurance sector, but also throughout the economy as a whole. This further means that the optimum level of policyholder protection is not achieved under Solvency I⁵⁵.

The new capital requirements under Solvency II move away from a crude one-model-fits-all approach to estimating capital requirements in a manner tailored to the entity. The Solvency requirements are also more comprehensive than before: whereas the Solvency I solvency requirements concentrated mainly on the liabilities (i.e. insurance risks), supervisory requirements for asset-related risks were mostly managed via volume limits on certain investment classes. Solvency II introduces requirements to quantify the risks associated with assets and simultaneously allows insurers to optimize their asset allocation. The Solvency II Directive also sets out the broad structure of the capital requirements as well as the quantitative standard for the calibration of the specific capital charges, a 99.5% value-at-risk measure, which the calibrations laid down in the Delegated Acts must respect. The new requirements for own funds are also more comprehensive in allowing supervisors to intervene earlier to ensure the robustness of an insurer, extending the ladder of supervisory intervention.

The Delegated Acts, in setting out the detailed rules on the methods, assumptions and standard parameters for the calculation of the capital requirements, should ensure that the standard formula is sufficiently risk sensitive by setting out capital charges that are appropriately tailored to the specific risks faced by insurers and reinsurers. Without a sufficiently risk-sensitive framework, capital resources would not be aligned with capital needs, leading to a sub-optimal capital allocation across the market. The requirements for own funds should also ensure that the capital held is of a nature that allows the timely and efficient absorption of losses, when they may occur.

Lack of transparency

⁵³ These terms are defined in Article 13(31), (32) and (33) of the Directive respectively.

⁵⁴ CEIOPS (2005), Answers to the European Commission on second wave of Calls for Advice in the framework of the Solvency II project

⁵⁵ These failings are extensively discussed in the impact assessment accompanying the Commission's proposal for the Solvency II Directive in 2007.

Under the current regime, there is a lack of harmonisation of Member States' transparency rules and supervisory practices, which makes it difficult for prospective and existing stakeholders to properly understand and compare the financial position of insurance companies, and the risks they are subject to. Lack of transparency is particularly acute in the valuation of assets and liabilities, with divergent applicable rules and divergent information being reported, and in governance (especially on remuneration practices).

To illustrate, in a recent study by Bank of America⁵⁶, "opaque disclosure" is mentioned as the third biggest problem from an investor's perspective, after risks of falling asset returns being insufficient to meet onerous guarantees.

Fragmented supervisory requirements

Solvency I is a minimum harmonising regime. Given the problems of risk-sensitivity in particular, many Member States have also concluded that the EU minimum requirements are not enough, and have taken up their own reforms. This has led to a divergent array of existing regimes, hampering the goal of a single market. In the area of reporting, Solvency I is completely silent, leaving Member States to set their own reporting requirements and / or letting supervisors make *ad hoc* requests whenever the information they have is considered not sufficiently up-to-date. This is particularly burdensome for cross border groups.

3.3.2. General problems

The following general problems arise out of the specific problems outlined above.

Difficult access to capital hindering economic recovery

As noted above, the insurance sector makes up the largest pool of institutional investors in Europe. An insufficient appetite for long-term investment can have the effect of limiting the flow of capital from this vital sector to the economy, which could ultimately serve to hinder recovery and growth in Europe.

Sub-optimal policyholder protection

Policyholders are not optimally protected under the Solvency I regime. This stems from two specific problems: the low risk-sensitivity of the regime, particularly the omission of market risks in capital requirements and the use of historic costs in valuation; the lack of transparency, due to divergent valuation methodologies, divergent reporting requirements and opaque remuneration practices. These may fuel excessive risk-taking, without policyholders and supervisors knowing it, thus negatively impacting policyholder protection.

Impediments to insurance market integration

The Solvency I framework sets out minimum standards that can be supplemented by additional rules at national level. Most Member States operate an 'EU-minimum plus' regime whereby insurers are subject to more stringent requirements than those set out in the Insurance Directives. In most cases this is driven by the need for a more risk-sensitive framework, which is seen by Member States to undermine policyholder protection. As well as undermining policyholder protection, the lack of risk sensitivity of the current regime also impacts the international competitiveness of EU insurers and reinsurers, because it does not

⁵⁶ Bank of America Merrill Lynch, Equity research, 9 December 2013

give appropriate credit for the use of risk mitigation techniques and diversification effects and does not provide for optimal allocation of capital.

These additional rules distort and undermine the proper functioning of the Single Market in insurance, which has the effect of increasing costs for EU insurers (and policyholders), hindering competition within the EU and undermining the international competitiveness of EU insurers and reinsurers. The lack of transparency, both in terms of divergent valuation and capital calculation methodologies and divergent reporting requirements, further hampers the integration of insurance industries and supervisory practices.

3.3.3. *Problem drivers*

Improper design of capital requirements on growth-fostering investments

A number of external factors can influence insurers' investment decisions. In the context of the Commission Green Paper on the long-term financing of the European economy⁵⁷, the following issues were identified, in addition to risk-return considerations: lack of insurers' expertise in credit analysis (e.g. in project finance or direct loans to SME)⁵⁸, tax regimes, accounting rules and prudential regulation. Among regulatory obstacles that could explain the hitherto limited appetite for certain asset classes are:

- limits on eligible investments: such limits existed under Solvency I but will be repealed once the Solvency II directive applies as of 1 January 2016; this issue is therefore resolved.
- artificial volatility in the prudential balance sheet: artificial volatility of capital resources due to valuation rules was addressed in detail by the Omnibus II directive, through the long-term guarantees package now included in the Directive⁵⁹; this issue is therefore resolved.
- design and relative calibration of capital requirements: this issue remains to be addressed in the Delegated Acts.

Capital requirements must reflect the risk of investments, in order to ensure policyholder protection; but they should not lead to an overly prudent investment strategy. The response of Insurance Europe to the Commission public consultation on the Directive adopted in 2007 estimated that the impact of an overly prudent investment strategy would be to reduce annual returns by 1.2% for life insurers and 1.65% for non-life insurers⁶⁰. Such an overly prudent strategy may ultimately prove detrimental not only to policy holders, since premiums would likely increase to compensate for the lower return, but also to the European economy in general, by unduly restricting efficient capital allocation flows from the biggest long-term finance providers to businesses in need of funding.

⁵⁷ COM(2013)150, 25 March 2013

⁵⁸ "The asset management functions of non-bank institutional investors may also be unaccustomed to dealing with more illiquid assets, tasks which were previously often carried out by monoline insurers which guaranteed such assets. Over time, this means that some investors may need to extend their existing skills to support their investment decisions." (Commission Green Paper, page 10)

"Many non-traditional investors remain wary of [less liquid assets]. Key to increasing their participation, perhaps, is a better understanding of the risks associated with this type of lending. (S&P, Global Infrastructure: how to fill a \$500 billion hole, January 2014)

⁵⁹ See Annex 1 for a description of the measures incorporated in the Directive.

⁶⁰ The response of Insurance Europe (then called the Comité Européen des Assureurs) refers to a study carried out by Swiss Re (http://media.swissre.com/documents/sigma5_2010_en.pdf) which compares the actual asset allocation of US insurers with risk free portfolio invested only in US Treasury securities.

Stakeholders' responses to the Green Paper on long-term financing insisted that the *relative* levels of the capital requirements for different assets, among other factors, can shape incentives to invest in certain asset classes and called for careful examination of the calibrations⁶¹. Against this background, the Commission decided to act on this problem driver and mandated EIOPA in September 2012 to revisit its advice, in order to remove any obstacle to long-term investment in the design and calibration of the standard formula, without jeopardising the prudential nature of the regime. The EIOPA report published in December 2013⁶² was fully taken into account into the design of the policy options for Delegated Acts, as discussed in section 5.

Excessive volatility stemming from equity prices

Excessive volatility in equity prices, which could deter insurers from investing in equity, was already recognised as an issue in the Directive. It provides that the calculation of the Solvency Capital Requirement must include a symmetric adjustment to the equity risk sub-module to allow for the volatility of the equity market. The Directive specifies that in periods of relative exuberance the equity capital charge can be up to 10 percentage points higher than the standard level; whereas in periods when markets are relatively depressed the equity charge can be up to 10 percentage points lower. The adjustment enables undertakings to smooth the impact of a change in the level of equity markets on its capital requirement over an appropriate period of time in order to mitigate undue pro-cyclical effects and avoid the risk of forced sales in the face of short-term adverse movements in equity markets. The functioning of the equity adjustment can therefore have an impact on investment in the real economy (including in SMEs, through private equity) by insurers. The Directive does not however specify the time period over which the relative level of the market currently should be assessed, only that it should be determined over an 'appropriate period' (see section 5.2).

Lack of consideration for the quality of insurers' own funds

According to the Directive, the capital resources of an insurer, known as its 'own funds', shall be classified into three tiers depending on their 'permanence' and their 'loss-absorbency'⁶³. This is an important lever in increasing the risk sensitivity of the prudential regime, compared to Solvency I where there was no tiering of own funds instrument. The Directive set out the limits on the proportions of tier 1, 2 and 3 own funds that can be held to cover the capital requirements (both the Solvency Capital Requirement and the Minimum Capital Requirement⁶⁴). The intention of the limits is to ensure that the own fund items will be available to meet any losses which the undertaking may incur. Items which have a fixed duration (such as debt issued by the undertaking) may not be available when they are needed, and would therefore be assigned to a lower tier. Ordinary share capital, by contrast, is both permanent and loss absorbent in the sense that its value can vary in response to losses incurred by the insurer.

Quantitative limits are set to determine the proportions of the SCR and MCR that must be covered by own funds of tiers 1, 2 and 3. Any amounts of own funds in excess of the caps

⁶¹ See the summary of responses, in particular to question 7 of the Green paper, available on http://ec.europa.eu/internal_market/consultations/2013/long-term-financing/docs/summary-of-responses_en.pdf

⁶² http://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments_2.pdf

⁶³ The own fund classification rules for CRD are also based on permanence and loss absorbency

⁶⁴ For more details on the SCR and MCR, see Annex 1.

applicable to tier 2 and tier 3 are not eligible for demonstrating solvency. The Directive sets the following minimum limits on eligible own funds⁶⁵:

- at least 50% of the MCR must be met with tier 1;
- 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.

Recognising that these are merely the minimum limits, the Directive includes an empowerment for Delegated Acts in which stricter limits should be set out⁶⁶.

Opaque and risk-fostering remuneration practices

The issue of remuneration in the financial sector and how it can induce excessive risk taking especially when remuneration practices are not subject to sufficient scrutiny by external stakeholders, has been identified and documented by the Commission during the last financial crisis (see for example the Commission Recommendation on remuneration policies in the financial services sector⁶⁷ and the Green paper on Corporate Governance in financial institutions and remuneration policies⁶⁸). In addition, the current macroeconomic environment, with a prolonged period of low interest rates, is putting insurers under pressure to generate financial returns, and may fuel a "hunt for yield" (see section 3.3.1). Such risky investment behaviours should be appropriately mitigated in the system of governance.

Divergent valuation basis for insurer's solvency position

For banks and insurers alike, the valuation of assets and liabilities is the starting point for the assessment of the solvency position, and the values that are put to individual balance sheet items provide the basis for the risk charges. Under Solvency II, these values are also relevant for the determination of own funds, since the Directive acknowledges the difference between the total assets and the total liabilities held by an insurer as an own funds element.

However, balance sheet valuation is not harmonized in the Union, and is, except for listed companies, governed by local generally accepted accounting principles (local GAAP). Under Solvency I, the valuation basis for the determination of an insurer's solvency position was thus not harmonized, leading to cross-border inconsistencies. Solvency positions in different member States were not directly comparable, affecting negatively the efficiency of the supervisory process, the transparency of solvency positions and convergence within the Union. The Directive addresses this issue by requiring market-consistent valuation of all balance items for supervisory purposes. It is up to the Delegated Acts to operationalize this principle, by determining which accounting principles may be used for valuation purposes.

Divergent supervisory reporting and disclosure

The Solvency II Directive will bring significant changes to the existing reporting and disclosure requirements. This puts burden on both the supervisors and the sector. In order for supervisors to judge the performance of insurers under the new rules, it will be critically important that they obtain the adequate information in a timely manner when the new regime,

⁶⁵ Article 98 of Directive 2009/138/EC

⁶⁶ Article 99 of Directive 2009/138/EC

⁶⁷ Recommendation 2009/384/EC, 30 April 2009

http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/mi0018_en.htm

⁶⁸ COM(2010)284 Final, 2 June 2010

http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm

becomes effective on 1 January 2016. This is also in the interest of insurers; many of them having already invested heavily in the preparation of Solvency II. The delegated acts will provide further details to the provisions in the Directive, in particular the nature and frequency of the information to be reported to supervisors.

The last financial crisis made it clear that more frequent reporting to supervisors, especially on the investment portfolios, is crucial for them to act in an efficient and timely manner. Failures of big companies as Enron, WorldCom, and Lehman Brothers or the haircuts or dramatic falls in the value of certain sovereign debts, preference shares or subordinated debts have proved that those supervisory authorities with quarterly information, for example on insurers' detailed investment portfolios, were in a much better position to rapidly identify those undertakings that were actually exposed to the failing companies and to decide the appropriate measures to be taken.

However, quarterly reporting cannot be currently considered as a wide spread and harmonised practice across EEA Member States.⁶⁹ In the absence of frequent reporting, supervisors have to make *ad hoc* information request to insurers when particular market stresses occur; such requests, being divergent and unpredictable, are therefore very burdensome. Harmonisation of reporting is particularly important for insurers operating in more than one Member State.

3.4. Baseline scenario, subsidiarity and proportionality

As for the *baseline scenario*, the empowerments contained in the Directive do not leave the Commission the option of not acting, as they are virtually all "shall" empowerments, and not to act would therefore be unlawful for the Commission⁷⁰. This is the case for the operational objectives concerning long term investments (both calibration of asset requirements and the parameters of the equity dampener), regarding valuation, and as regards reporting. Only regarding the composition of own funds does the Commission have, in theory, the option of setting out limits that do not go beyond the minima laid down in the Directive (but the empowerment is clearly suggesting that the Commission should do so⁷¹). Regarding the frequency of submission of information to supervisors, in a regulatory system based on a certainty level of 99.5% value at risk over a time horizon of one year, annual reporting is the minimum possible frequency⁷², and can be considered as a *de facto* baseline scenario. In the evaluation tables in section 5 below, these "baseline options" are analysed as having zero effect, and other options are evaluated relatively to them.

The issue of *subsidiarity* was covered in the impact assessment for the Directive. It was considered that the general and specific problems and problem drivers identified in the area of insurance regulation and supervision could only be effectively resolved via a maximum harmonizing approach at EU level. This was confirmed by the legislator in 2009, when the Directive was adopted. The problems and objectives discussed in this impact assessment are considered against the background of the existence of a maximum harmonizing Directive, already legally in force and requiring completion via Delegated Acts. Regarding

⁶⁹ External Study by Deloitte for the Impact Assessment of Solvency II, 2010, p.356

⁷⁰ If the Commission did fail to act upon the empowerments, while still allowing the Directive to enter into application, member States would have no choice but to adopt their own national rules corresponding to the subjects covered by the empowerments; these national rules could of course vary between member States, harming the maximum harmonisation objective of the Directive. Such a scenario cannot be impact assessed.

⁷¹ Article 99 of Solvency II: The Commission shall adopt delegated acts in accordance with Article 301a laying down [...] the quantitative limits referred to in Article 98(1)".

Article 98(1): "Those limits shall be such as to ensure that *at least* ..."

⁷² The Directive (article 102) requires that the Solvency Capital Requirement is calculated and reported at least every year.

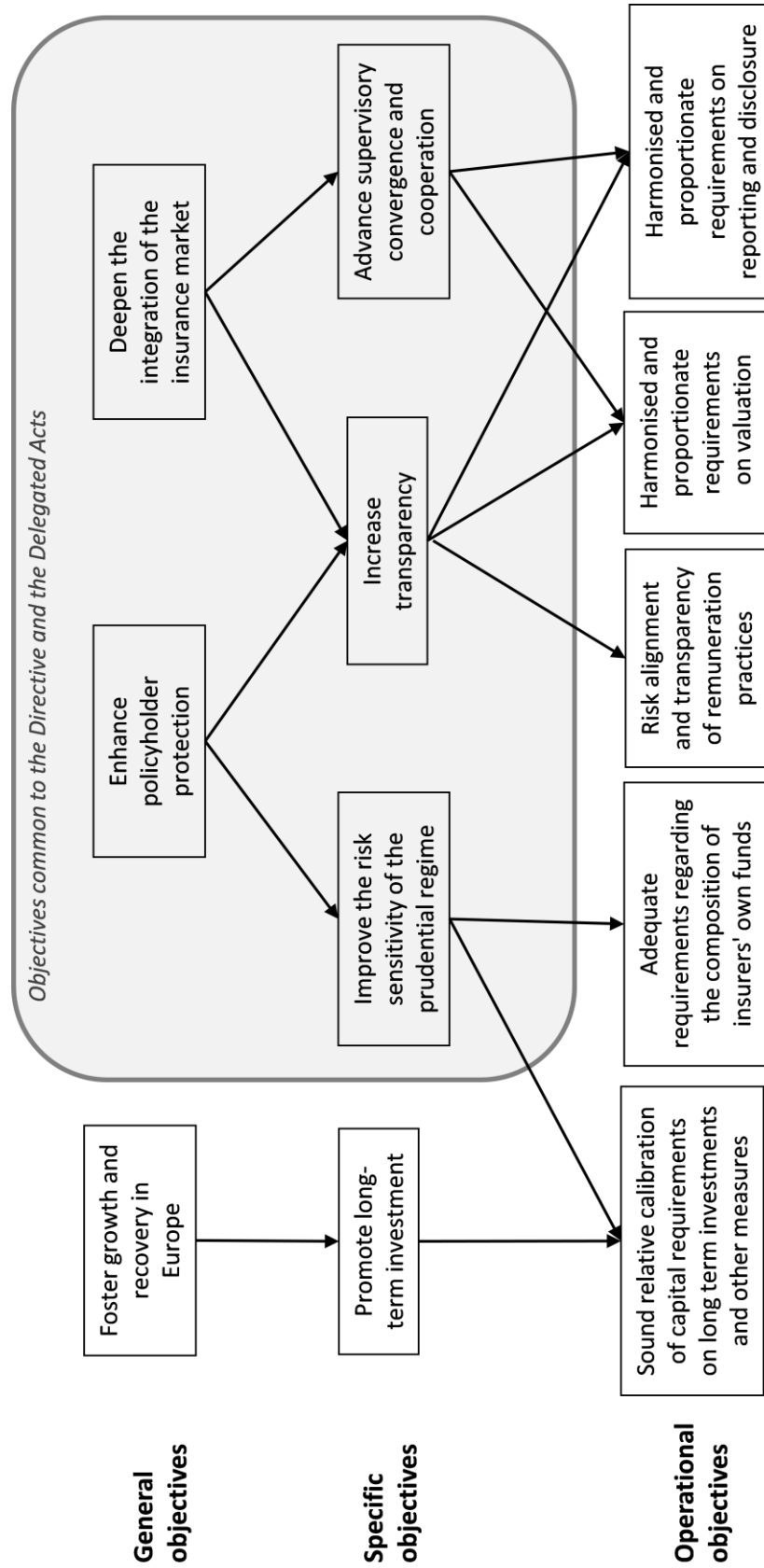
remuneration, since the Directive is silent on this issue, the Commission could decide to act on other elements of the system of governance but not on remuneration. However the objective to promote sound and transparent remuneration practices only emerged after the Directive was completed in 2009, and was clearly announced in the Recommendation of 2009 and Green paper on corporate governance in financial institutions and remuneration policies of 2010, mentioned in the previous section. The issue of remuneration has since been tackled in legislation for other financial sectors, and the Green paper of 2010, in particular, called for similar legislative action in the insurance sector⁷³. Almost four years have elapsed since then, due to the delays in concluding the Omnibus II directive, therefore the Delegated Acts are the appropriate instrument to act on remuneration in the insurance sector (the legal basis is explained in detail in section 5.4).

The issue of *proportionality* is relevant for the operational objectives regarding capital requirements for investments, quality of own funds valuation and reporting and disclosure. For those objectives, there are options which impose higher costs on insurers. Higher costs arise, the more information must be reported and the more frequently, the more insurers are obliged to use IFRS for valuation rather than local accounting standards, and the more tier 1 capital which is required for own funds. In capital requirements, the proportionality issue is complex because more granular options are less onerous in terms of capital (lower capital requirements) but more complex and therefore more costly to implement. These issues are taken into account in the assessment of the options in section 5 below. Regarding the parameters of the equity risk dampener (section 5.2), there are no options which would impose a greater burden for insurers or any particular category of insurers.

⁷³ See section 5.7 of the Green paper quoted in footnote 71.

4. OBJECTIVES

Figure 2: Objectives tree



4.1. General objectives

4.1.1. Foster growth and recovery in Europe

Given the current macroeconomic context and the role of insurers as long-term investors, the objective of stimulating smart, sustainable, inclusive, resource-efficient and job-creating growth now has to be considered when proposing prudential regulation, in line with the priorities of the Europe 2020 Strategy and the Commission Green Paper on the long-term financing of the European economy. This is a new general objective compared with the impact assessment on the Commission's Solvency II proposal in 2007, on the eve of the financial crisis, reflecting the changes economic circumstances since then.

4.1.2. Enhance policyholder protection

Policyholder protection is the primary reason for prudential regulation and supervision, and agreeing what level of protection policyholders should be achieved has proved to be one of the major stumbling blocks in creating a Single Market in insurance. The lack of risk sensitivity and lack of a harmonised supervisory reporting and transparency towards the public of the Solvency I EU regime undermined policyholder protection.

4.1.3. Deepen the integration of the EU insurance market

Legislative action has been taken over the last 35 years to facilitate the development of a Single Market in insurance services (see section 3.2. above). Nevertheless, obstacles remain to the full integration of the EU insurance market. The main reasons for this are the divergent supervisory requirements and the lack of transparency towards the public.

4.2. Specific objectives

4.2.1. Promote long-term investments

In the Communication of 27 March 2014 on the long-term financing of the European economy, as a follow-up to the Green Paper, the Commission announced concrete actions in the Solvency II delegated acts to stimulate long-term investments by insurers⁷⁴. The corresponding operational objective is set out in the following section, in particular the list of asset classes that the Commission considers to be important to promote.

4.2.2. Improve the risk sensitivity of the prudential regime

The lack of risk sensitivity of the Solvency I regime distorted allocation of capital resources both between lines of business and across the industry as a whole. It prevented capital allocation from adequately reflecting the risks borne by insurers, i.e. it is not allocated where it is most useful to absorb possible losses and to prevent insurers from failing. The regime could be made more risk sensitive with regards to the quality and composition of insurers' own funds and with regards to the capital requirement on insurers' investment.

4.2.3. Increase transparency

The absence of public disclosure requirements under Solvency I and therefore the lack of harmonisation of Member States' rules in this regard, make it difficult for prospective and existing stakeholders to properly understand and compare the financial position of insurers

⁷⁴ See page 6 of the Communication (COM 2014(168)).

and the risks to which they are subject. The Directive introduces common reporting and public disclosure requirements, both on quantitative issues like valuation and on qualitative issues such as risk-management within the system of governance. It is up to the Delegated Acts to specify the elements of the system of governance, and of the reporting to supervisory authorities.

4.2.4. Advance supervisory convergence and cooperation

A number of insurance groups operate in several Member States and the cross-border provision of services has also increased. However, Member States have widely differing supervisory rules and practices. These differing rules and practices undermine the Single Market and increase costs for insurers operating in more than one Member State, especially with regard to divergent reporting requirements. This regulation should advance supervisory convergence and co-operation. The provisions on governance, e.g. on principles on remuneration policy, and the preparatory guidelines of EIOPA for Solvency II are already beginning to mitigate this.

4.3. Operational objectives

4.3.1. Sound relative calibration of capital requirements on long term investment and other measures

Consistently with the definitions for "long-term investments" and "long-term financing" (see annex 4), the mandate given by the Commission to EIOPA in September 2012 to investigate possible facilitation of long-term investment via the design and calibration of the standard formula for capital requirements focused on the following asset classes:

- infrastructure financing and other long-term financing through project bonds, other types of debt and equity;
- SME financing through debt and equity;
- socially responsible investments (SRI) and social business financing through debt and equity;
- long-term financing of the real economy through securitisation of debt serving the above mentioned purposes.

This list of assets to be fostered reflects the Commission's conclusions, on the basis of the Green Paper consultation, that infrastructure and SMEs are key contributors to sustainable growth. The Commission is also committed to creating a favourable environment for the development of social business in Europe, as illustrated by the wide-ranging Social business initiative launched in 2011⁷⁵. Besides, fostering the recovery of sustainable securitisation markets, while avoiding flawed business models that contributed to the recent financial crisis, also ranks high among the Commission's priorities. This objective is fully shared with the European Central Bank and the Bank of England, which issued a noteworthy joint paper ahead of the G20 Finance Ministers meeting in April 2014, calling for action to stimulate the impaired EU securitisation market⁷⁶.

The Commission has also put forward, in other financial sectors than insurance, a number of initiatives to support long-term financing. For example, new investment vehicles such as

⁷⁵http://ec.europa.eu/internal_market/social_business/index_en.htm

⁷⁶ Joint ECB-BoE paper dated 11 April 2014, "The impaired EU securitisation market: causes, roadblocks and how to deal with them" (<http://www.bankofengland.co.uk/publications/Documents/news/2014/paper070.pdf>)

European Venture Capital Funds (EVCF)⁷⁷ and European Social Entrepreneurship Funds (ESEF)⁷⁸ were adopted in 2013 and the Commission proposed to create European Long-term Investment Funds (ELTIF)⁷⁹. Similarly, the Commission is supporting a number of schemes designed to help SME's access to funding, involving in particular the European Investment Bank and the European Investment Fund⁸⁰. It is important that the Delegated Acts duly take into account these initiatives and ensure consistency in their treatment across financial sectors (e.g. banks and insurance undertakings, acting as investors in those schemes).

Taking into account the final report delivered by EIOPA in December 2013⁸¹, the Delegated Acts aim to strike a balance between incentivising investment in those asset classes (through different *relative* calibrations of capital requirements) and the general objective of policyholder protection. Where possible and justified by robust quantitative arguments, the design of a tailored treatment for those asset classes has been considered. Options examined in section 5.1 reflect the evolution over time (between the negotiations on the Solvency II Directive until nowadays) of the policy agenda in balancing the general objectives of fostering growth in Europe while maintaining a high policyholder protection standard.

4.3.2. *Adequate requirements regarding the composition of insurers' own funds*

To improve the risk sensitivity of the regime, the Delegated Acts aim to introduce more risk-sensitive requirements in the composition of insurers' own funds, within the limits set out in the Directive. The quality of the capital allocated is an important issue within the general objective of policyholder protection. This is in line with the revisions introduced under Basel III, whereby banks are required to hold a higher proportion of tier 1 capital than under Basel II⁸².

4.3.3. *Risk alignment and transparency of remuneration practices*

Legislative measures have been proposed to ensure sound remuneration practices in the banking sector and investment sectors. In June 2010, the Commission Green paper on corporate governance in financial institutions and remuneration policies called for similar legislative action in the insurance sector⁸³.

4.3.4. *Harmonised and proportionate requirements on valuation*

By requiring market-consistent valuation for the purpose of determining the solvency position, the Directive provides for more transparency and convergence in the new regime. On the level of the Delegated Acts, it must be decided to what extent this high-level principle should be translated into concrete accounting rules. In order to avoid imposing unnecessary additional costs on undertakings and supervisors, these rules however should strive to be compatible with the non-harmonized accounting practice in Member States.

⁷⁷ http://ec.europa.eu/internal_market/investment/venture_capital/index_en.htm

⁷⁸ http://ec.europa.eu/internal_market/investment/social_investment_funds/index_en.htm

⁷⁹ http://ec.europa.eu/internal_market/investment/long-term/index_en.htm

⁸⁰ See the Commission staff working document accompanying the Communication on long-term financing of the European economy (SWD(2014)105 final, http://ec.europa.eu/internal_market/finances/docs/financing-growth/long-term/140327-staff-working-paper_en.pdf)

⁸¹ http://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments_2_.pdf

⁸² Banks are required to hold 4.5% of risk-weighted assets in common equity (up from 2% in Basel II) and 6% in tier I capital (up from 4% in Basel II)

⁸³ See section 5.7 of the Green paper quoted in footnote 71.

4.3.5. *Harmonised and proportionate reporting requirements*

Reporting requirements vary widely across Member States. The Delegated Acts seeks to further specified and harmonise reporting for supervisory purposes, while ensuring that these requirements are not too burdensome for smaller or less complex undertakings.

Frequency of reporting to supervisory authorities is considered as a key element since the recent financial crisis has proved that up-to-date information is critical to rapidly assess the impact on insurers' financial position of any significant adverse unexpected event.

5. POLICY OPTIONS AND COMPARISONS

Selecting the policy options to assess

Much of the content of the Delegated Acts fills in the operational machinery of the framework set out in the Directive in a technical manner that is largely uncontroversial among stakeholders and Member States. EIOPA's advice was for instance uncontroversial in areas in which there is enough data and experience to reliably set capital calibrations or where there is an established best practice within the European market (such as the calibration of the mortality stresses). Other areas such as the treatment of long-term guarantees and third-country equivalence were controversial among Member States but are addressed in detail in the Directive following the Omnibus II negotiations.

Annex 2 sets out all of the 76 empowerments for Delegated Acts and Regulatory Technical Standards⁸⁴ in the Directive along with a description of how each has been taken up. Since it is not possible for this report to assess each of the empowerments individually, the options assessed focus on the more controversial areas of EIOPA's advice. The options assessed have been selected to cover the most important and representative issues from each of the three pillars of Solvency II and each of the areas of the objectives and problem trees. The areas that are merely technical, have been settled in the Directive or are uncontroversial are not assessed in detail in this section since they do not entail particular policy options.

5.1. Sound relative calibration of capital requirements on long term investments

The operational objective described in section 4.3.1 is to lay down different capital requirements for different asset classes, where the *relative* calibrations will create the desired investment incentives. To achieve this, the design of the standard formula must be granular enough in defining the “buckets”⁸⁵ for different asset classes (e.g. equities, bonds, securitisations, etc.).

The Directive already prescribes a metric for the calibration of risk factors on each of those buckets (99.5 % Value-at-Risk, as explained in overview of the Directive in Annex 1). This metric effectively imposes the level of policyholder protection, which cannot be changed by the Delegated Acts. Therefore, the political decision lies in the definition of asset buckets in the formula.

The Commission has already announced (see objectives in section 4.3.1) which asset classes it considers essential to foster. However, the political decision to create a tailored treatment for certain assets must be supported by appropriate data, to derive the risk factors according to the

⁸⁴ Which are being taken up as Delegated Acts in the first instance

⁸⁵ “Buckets” is shorthand for classes or groupings of assets to which specific risk factors are then assigned.

metric prescribed in the Directive. Splitting asset classes into excessively specific buckets would entail less statistically robust calibrations, because market data serving as a basis to calibrate the factors becomes scarce when buckets become very specific (it may even be impossible to find suitable data to calibrate factors on very specific classes). In addition, a more granular approach would entail even more complexity for undertakings and supervisors, as the investment portfolios must be broken down according to the prescribed granularity.

Therefore, the discussion on policy options in the Delegated Acts focuses on the definition of assets buckets, varying the level of granularity of the formula.

Figure 3: a two-step process in designing the formula for market risks

Designing the formula for market risks, 1st step: define asset classes or "buckets"

The Directive does not impose any specific number of buckets for the Delegated Acts, only prescribing (art. 105) a different treatment for equity investments (subject to the equity risk sub-module in art. 105(5)(b)) and debt investments (subject to the spread risk sub-module in art. 105(5)(d)). The options therefore pertain to the level of granularity within these two classes: it is up to the Delegated Acts to set out the number and granularity of specific buckets within the broader equity and debt categories, including where possible more specific buckets for assets that are expected to be conducive to growth and jobs.

But there is a trade-off between risk-sensitivity and simplicity in implementation because undertakings are required to break down their investment portfolios into the different asset buckets and calculate the capital requirements resulting from the prescribed risk factors on each bucket.

Designing the formula for market risks, 2nd step: calibrate risk factors for each bucket

Once asset classes have been defined, it is necessary to set the value of the corresponding risk factors, which correspond to stress scenarios that undertakings will have to implement on their investment portfolios (e.g. "fall in the price of equities by 39%"). Risk factors for

Description of the options

In order to achieve the operational objective of a sound relative calibration of capital requirements on long-term investments, the following options were considered:

Option 1 – This option provides for minimum granularity, in accordance with the Directive. There would be only two relevant buckets for long-term investment: one bucket with a single, average, risk factor for all equities (mixing listed equity of large corporates, private equity and hedge funds for example) and one bucket for all debt private debt instrument (bonds, loans and securitisations) with risk factors depending only on credit ratings. This option is considered as the baseline scenario, as it corresponds to the minimum action under the "shall" empowerment to adopt delegated acts.

Option 2 – This option, more granular than option 1, reflects the standard formula as it was envisaged and stabilised in 2011, after the fifth quantitative impact study (QIS5). This option was tested in QIS5 in 2010 and subsequently in the long-term guarantees technical assessment

on data from year end 2012⁸⁶. This option is a compromise on granularity and simplicity, whereby:

- the equity bucket would be straightforwardly split into two buckets: one for equities listed on regulated OECD markets and one for other equities, including private equities and hedge funds, because these two classes clearly have different features.
- the private debt bucket would be split in two (on the one hand, bonds and loans with a tailored treatment for high-quality covered bonds, and all securitisations on the other hand). Also, the spread risk factors would depend not only on ratings, but also on duration. Indeed, debt instruments with longer maturity are more sensitive to fluctuations in spread, but risk factors would increase less than linearly with duration to maintain strong incentives to invest into long-term debt instruments for insurers with long-term liabilities⁸⁷.

Option 3 – This option is a refined version of option 2, reflecting the latest EIOPA technical advice, from December 2013⁸⁸. EIOPA broadly confirmed the design and calibrations envisaged in the October 2011 draft of the Delegated Acts, either because of the market data EIOPA deemed appropriate to use for each bucket, or because of the lack of consensual definition and/or robust market sources on other asset classes (infrastructure, socially responsible investments and social business financing for example). However, EIOPA did recommend criteria to distinguish high-quality securitisation and more favourable capital requirements on such investments. This is the first step taken in this direction by public authorities, and it essential to revive safe and sustainable securitisation markets in Europe, a priority discussed in the Communication on long-term financing.

The proposed definition for high-quality securitisation is based on a dozen criteria pertaining to the structure of the transaction, the nature of underlying assets, the underwriting process and the transparency for investors⁸⁹. Detailed information about those criteria and how they avoid earlier flaws in the securitisation market, such as the ones that led to the "sub-prime" crisis, is available in Annex 5. Compared to the one-size-fits-all-securitisations factors under option 2, EIOPA also recommended that the risk factors associated with high-quality securitisation would be reduced up to 40%, while the risk factors for other securitisations would mechanically increase in similar proportions.

Figure 4 below, shows risk factors under each option, on a typical equity and on a typical 5-year, AAA rated debt instrument.

⁸⁶ Following QIS5, the issue of long-term guarantees was judged to be political in nature and escalated by the co-legislators to the Directive in the context of the discussions on Omnibus II. Work on the draft Delegated Acts was largely suspended in 2012 and 2013 to focus on Omnibus II.

⁸⁷ This is the so-called "kinked approach" for spread risk, which was introduced after QIS5.

⁸⁸ EIOPA technical report on the Standard formula design and calibration for certain long-term investments, http://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments_2_.pdf

⁸⁹ See Section 7.5, page 119 of the EIOPA report (quoted above) and Annex 5.

Figure 4: Summary of the policy options regarding the treatment of long-term investments

	Option 1 (Standard formula no more granular than the directive)	Option 2 (Standard formula as in 2011 – after QIS 5)	Option 3 (including EIOPA advice on high-quality securitisation)	Option 4 (standard formula with maximum refinement to foster long term investments)
Equities	One-size-fits-all equities treatment (49% risk factor before dampener)	Two buckets: - equities listed on regulated markets (39% risk factor, before dampener) - other equities e.g. emerging markets, hedge funds and private equity (49% risk factor, before dampener)	Two buckets: - equities listed on regulated markets (39% risk factor, before dampener) - other equities e.g. emerging markets, hedge funds and private equity (49% risk factor, before dampener)	Two buckets: - equities listed on regulated markets, <u>EVCF, ESEF, other private equity funds</u> (39% risk factor, before dampener) - other equities e.g. emerging markets, hedge funds (49% risk factor, before dampener)
Corporate bonds and loans	One-size-fits-all corporate bonds and loans and securitisations,	Risk factors depending on <u>ratings and duration</u> [4.5% for 5Y/AAA], with a specific treatment for high-quality <u>covered bonds</u> [3.5% for 5Y/AAA]	Risk factors depending on <u>ratings and duration</u> [4.5% for 5Y/AAA], with a specific treatment for high-quality <u>covered bonds</u> [3.5% for 5Y/AAA].	Risk factors depending on <u>ratings and duration</u> [4.5% for 5Y/AAA], with a specific treatment for high-quality <u>covered bonds</u> [3.5% for 5Y/AAA]. Allow the <u>use of proxy ratings</u> for certain unrated instruments. <u>Recognise the risk-mitigating effect of collateral on spread risk on unrated bonds and loans.</u> Recognise <u>guarantees</u> provided by European Investment Fund and European Investment Banks and assign a 0% risk factor.
Securitisation	with risk factors depending on <u>ratings</u> only [10% for 5Y/AAA]	Two buckets with risk factors depending on <u>rating and duration</u> : - <u>securitisations other than resecuritisations</u> , [35% for 5Y/AAA] - <u>resecuritisations</u> [100% for 5Y/AAA]	Three buckets with risk factors depending on <u>rating and duration</u> : - <u>high-quality securitisations</u> , [21.5% for 5Y/AAA] - <u>other securitisations</u> , [60% for 5Y/AAA] - <u>resecuritisations</u> [100% for 5Y/AAA]	Three buckets with risk factors depending on <u>rating and duration</u> : - <u>high-quality securitisations</u> , [10.8% for 5Y/AAA] with risk factor capped at the level of the underlying loans. - <u>other securitisations</u> , [60% for 5Y/AAA] - <u>resecuritisations</u> [100% for 5Y/AAA] Infrastructure <u>project bonds</u> , even when tranchéd, should be treated as corporate bonds. Recognise <u>guarantees</u> provided by European Investment Fund and European Investment Banks and assign a 0% risk factor.

Option 4 – Building on option 3, this is the most far-reaching option in taking into account long-term investment objectives, ensuring consistency with other recent policy initiatives by the Commission and implementing the actions announced in the Communication in March 2014. It includes the following amendments to Option 3:

- a less onerous treatment of certain types of investment funds newly-created by EU legislation (European Social Entrepreneurship Funds and European Venture Capital Funds)⁹⁰, because they would be allocated to the less risky equity buckets, along with listed equities, even when these funds could be privately traded only. Such a deviation from EIOPA's advice is justified by the empirical analysis of a more appropriate private equity index than the one used by EIOPA⁹¹.
- on the same grounds, a similarly less onerous treatment of investments in closed-ended, unleveraged alternative investment funds, which captures in particular other private equity funds that do not take the form of one of the European funds mentioned above. This is consistent with the banking structural reform proposed by the Commission⁹², whereby such investments would be exempted from the ban on proprietary trading.
- a more favourable treatment of high-quality securitisation than recommended by EIOPA under option 3. The criteria for defining high-quality securitisation are the same as in option 3 (i.e. aligned on EIOPA's recommendation) but only the risk factors applicable to the high-quality securitisation are lowered under this option. Risk factors for high quality securitisation would be reduced by more than half compared to option 3, by using market data on a longer timeframe to reduce reliance on data from crisis years⁹³. In addition, the credit-enhancement brought by senior tranches is recognised: the calibrations applicable to high-quality securitisation positions cannot be higher than those applicable to underlying unrated loans if they were held directly⁹⁴. This will not threaten financial stability as high quality securitisation would still remain at least two times more onerous than corporate bonds of the same rating.
- investment in infrastructure project bonds would be treated as corporate bonds, even when credit risk is tranching, instead of being treated as securitisation. This is aligned on their treatment under the banking regulation⁹⁵.

⁹⁰ Regulations creating ESEF (Regulation (EU) No 346/2013) and EVCF (Regulation (EU) No 345/2013) were adopted in April 2013 by Council and Parliament. The ELTIF regulation was proposed by the Commission in June 2013 (COM 2013/462) and negotiations are on-going. It is therefore legally impossible to cater explicitly for those funds at the time of adoption of the Delegated Acts.

⁹¹ Empirical analysis of the LPX NAV50 index of private equity funds over 2003-2013 shows that the 99,5% VaR is around 38%, justifying to allocate private equity investment in the least onerous equity bucket (subject to a 39% stress, before equity dampener). In contrast, EIOPA based its recommendation on the LPX50 Total Return index, which is less appropriate than LPX NAV50 because it does not reflect prices of the funds themselves but instead prices of the (listed) shares of large management companies that also manage other asset classes than private equity (e.g. real estate).

⁹² COM/2014/043 final, article 6(3) (http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm)

⁹³ This was done by comparing the corporate bond calibration based on a longer historical data set (1999-2012) against a calibration based only on data from 2006-2012; the comparison showed that the corporate bond calibration would double if only the 2006-2012 data were used, suggesting that the EIOPA proposal is a two fold overestimation of the risk factors for high quality securitisation.

⁹⁴ Only positions in senior tranches can qualify as high-quality securitisation positions.

⁹⁵ See recital (50) of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

- as far as debt investments are concerned, option 4 would also include several measures focused on unrated bonds and loans. Investments in unrated bonds, issued for example by medium-sized enterprises on private placement markets, accounted for 4.6% of the total corporate bond portfolio held by insurers at the end of 2007.
 - insurers investing in unrated bonds and loans could use proxy ratings and get a less onerous capital requirement (e.g. using the rating of the issuer or of other debt instrument which are part of the same issuing programme). The same provisions exist in the banking regulation⁹⁶ and contribute to reducing reliance on rating, by avoiding a punitive treatment for unrated instruments.
 - where unrated debt instruments are guaranteed by collateral, the risk-mitigating effect of the collateral on spread risk would be recognised.
 - where debt instruments are fully guaranteed by multilateral development banks, such as the European Investment Bank or the European Investment Fund (in particular under the COSME funding programme for SMEs), they are exempted from any capital requirement for spread and concentration risk, as is the case under the banking regulation⁹⁷. Indeed, the due-diligence in screening the projects and the credit enhancement provided by these two European bodies considerably reduce the risk of such investments.

Analysis of the options

A less granular approach such as option 1 is simpler for insurers to implement and authorities to supervise, but it would rely overly on credit ratings and be less sensitive to the lower risk-profile of high-quality long-term assets, thus not providing strong investment incentives for insurers. Therefore, it is the least effective, efficient and coherent option, ignoring all other policy initiatives of the Commission in the area of long-term financing.

Option 2, more risk sensitive, was considered the preferred policy option by Member States in the expert group until 2011, before fostering long-term investment became a priority policy objective in the European and international agenda.⁹⁸

Option 3 includes the EIOPA proposal on high-quality securitisation, which was welcomed by all stakeholders, as it is the first initiative to pave the way for reviving sustainable securitisation markets. Nevertheless, the industry⁹⁹, the European Central Bank and the Bank of England¹⁰⁰ and a majority of Member States experts, contested that the calibration of the risk factors proposed by EIOPA was still punitively high because the only available market data covers mostly crisis years (from 09/2006 to 12/2013 as explained in section 7.10 of the EIOPA report) therefore ignoring major structural reforms that have since come into application to fix the securitisation market (these reforms are described in Annex 5). The solution, included in Option 4, is to extrapolate on the basis of corporate bonds prices which are available over a much longer period.

⁹⁶ See article 139 of Regulation (EU) No 575/2013.

⁹⁷ See articles 117 and 235 of Regulation (EU) No 575/2013.

⁹⁸ See for example the G20's 2014 agenda for growth and resilience:

https://www.g20.org/g20_priorities/g20_2014_agenda

⁹⁹ See comments from AFME (Association for Financial Markets in Europe) on <http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10143> which were echoed by PCS (Prime Collateralised Securities).

¹⁰⁰ See footnote 80.

Option 4 is the most effective in promoting long-term investment by improving the risk-sensitivity of capital requirements beyond option 3. But it increases the complexity of the standard formula by creating a "niche" treatment for certain assets, therefore option 4 is only considered as efficient as option 3 (not more efficient). Option 4 is however the most coherent option, because it provides for additional alignment with the banking regulation (eg. on instruments guaranteed by the European Investment Fund or European Investment Banks, as well as the treatment of infrastructure project bonds) and is consistent with the regulations proposed in recent years that create EU-labelled investment funds (EVCF, ESEF) as well as with the proposal for the structural banking reform (on the treatment of closed-ended, unleveraged alternative investment funds). With regards to the calibration of the risk factors for securitisations, it uses the broadly acclaimed definition for high-quality securitisation, as proposed by EIOPA, and goes further in lowering the corresponding risk factors (by relying on a more broad basis of data and by taking into account the calibrations applicable to underlying unrated loans if they were held directly). This option recognises the credit-enhancement brought to high-quality securitisation positions, since the calibrations for the senior tranches benefitting from this credit enhancement cannot be higher than those applicable to underlying unrated loans. This will help to sustain the recovery of simpler, more standardised and transparent securitisation markets which are essential to develop a more market-based economy, less reliant on banks for funding.

Option 4 is also the most consistent with the broader policy objective of avoiding overreliance on credit ratings, by avoiding any punitive charge on unrated bonds and loans (allowing the use of proxy ratings and recognising the risk-mitigating effect of collaterals on spread risk for unrated debt) and by introducing a definition of high-quality securitisation¹⁰¹ that is largely independent from ratings. Annex 6 outlines in more details how overreliance on credit ratings is avoided in EU financial services legislation and in the Solvency II Delegated Acts in particular.

Therefore **option 4** is the preferred option. It is consensual among Member States experts and it goes as far as is prudentially possible to accommodate industry concerns on the basis of EIOPA's technical advice, without threatening financial stability. In particular, efforts to foster investment in high quality securitisation were welcomed by the European Central Bank and the Bank of England¹⁰².

Figure 5: Comparison of policy options against effectiveness, efficiency and coherence criteria

Objectives Policy option	EFFECTIVENESS:		EFFICIENCY	COHERENCE
	Promote long term investment	Improve the risk sensitivity of the prudential regime		
Option 1 Standard formula no more granular than in the directive (baseline)	0	0	0	0
Option 2 Standard formula as in 2011	+	+	+	≈

¹⁰¹ See Annex 5

¹⁰² See footnote 80.

Option 3 Standard formula after including EIOPA advice on securitisation	++	++	++	+
Option 4 Standard formula with maximum refinement to foster long term investment	+++	+++	++	++

Figure 6: Comparison of the impact of policy options on stakeholders

	Policyholder protection	Insurance Undertakings	SME insurers	SMEs in the general economy	Member States
Option 1	0	0	0	0	0
Option 2	≈	+	+	≈	≈
Option 3	≈	+	+	+	+
Option 4	≈	++	+	++	++

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

The positive impact for SMEs increases in options 3 and 4 as they include measures focused on helping SME funding (treatment of high-quality securitisation, favourable treatment of collateralised unrated debt, recognition of EIF and EIB guarantees as described above). From the point of view of insurance undertakings, each option from option 1 to option 4 would provide for progressively more tailored capital requirements for their investments, allowing for statistically-justified lower capital requirements if they pick long-term, high quality assets. However, because option 4 is very granular, it is more complex to implement in particular for SME insurers) for example when it comes to checking whether investments in securitisation qualify as high quality. Nevertheless, given that insurers' investment in securitisation represent a tiny share of their portfolio (around 2% of total investments, see section 3.3.1) the burden of checking whether an insurer's securitisation investments qualify as high-quality, to determine the applicable risk charge, is obviously acceptable.

Option 4 will have no significant impact on policyholder protection and is not creating additional risks to financial stability, because capital requirements are still calibrated in a prudent manner and do not deviate from the 99,5% VaR general risk metric prescribed in the Directive¹⁰³. Assuming Option 4 will successfully incentivise insurers to adopt long-term investment strategy into better quality assets (e.g. simpler and more transparent securitisation products), it may have a beneficial impact for policyholders.

Besides, the impact on Member States reflects the indirect impact on growth of stimulating long-term investment in the real economy, in particular in SMEs.

¹⁰³ Option 4 is the most granular, but more granularity *per se* does not mean less prudence, as long as the 99,5 % VaR metric (imposed by the directive) is respected in calibrating each bucket. The definition of high quality securitisation is strict to prevent another 'sub-prime' crisis, and high quality securitisations remain subject to risk factors around two to three times more severe than corporate bonds of the same duration. Risk factors for other securitisations remain even higher, up to ten times higher for resecuritisations.

5.2. Sound calibration of the equity risk dampener

According to the Directive, the standard formula for the calculation of the Solvency Capital Requirement must include a symmetric adjustment to the equity risk sub-module to allow for levels of relative exuberance or depression of the equity market.

The Directive does not however specify the time period over which the relative level of the market currently should be assessed, leaving this to the Delegated Acts, and specifying only that it should be determined over an 'appropriate period'. According to the Directive¹⁰⁴, the time period should be set to ensure that the following objectives are met:

- the equity adjustment should allow sufficient time for undertakings to rebalance their profile in a stressed scenario;
- the adjustment should reduce pro-cyclical effects on the balance sheet of insurance and reinsurance undertakings, in particular a rise in the equity charge in the middle of a crisis;
- the overall equity charge should remain sufficiently risk sensitive after application of the adjustment;
- the adjustment should mitigate the need for forced sales of assets in order to restore the capital position following a fall in equity markets;
- the adjustment should not increase the volatility of insurers' exposure to equity markets.

Against the background that 12 months is the time period over which the risk measurement of the Solvency II capital requirements apply, there are two options to consider:

Option 1 (baseline): average out the market values over the past 12 months;

Option 2: average out the market values over a period of more than 12 months (36 months).

EIOPA's final advice¹⁰⁵ recommended option 1 on the basis that it aligns the period over which the dampener applies with the period of the risk measurement. EIOPA preferred this to option 2 on the grounds that a relatively shorter period means the adjustment is more risk-sensitive in the sense that the equity charge is more aligned with current market conditions.

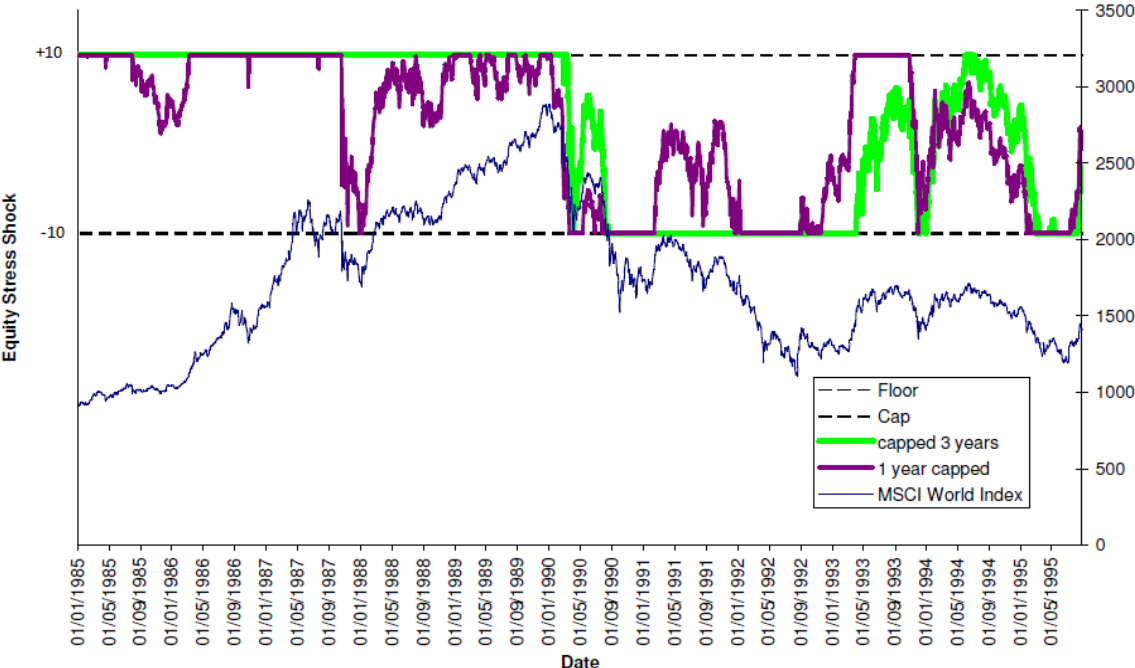
However, the continuous developments in financial markets since then have evidenced the importance of ensuring that excessive volatility in the capital requirements is adequately mitigated. According to the report produced by Deloitte, a period greater than 12 months would be appropriate to allow more time for insurers to adjust their equity portfolios to market changes¹⁰⁶. This would have a stabilising effect on the movement of capital following a fall in the equity market and would reduce the risk of pro-cyclical price spirals. Over a longer averaging period the capital charge itself would also be more stable and less susceptible to short term price movements that are not sustained in the medium to long term. This can be seen in the graph below over the period spanning 1991 and 1992; the 1 year average incorporates the short periods of upward price movement even though the long-term trend before and after this period is downward. Such frequent changes in the level of the

¹⁰⁵ EIOPA's Advice for Level 2 Implementing Measures on Solvency II: Equity risk sub-module

¹⁰⁶ See section 10.1.7 of the Deloitte report quoted in section 2.2.2.

equity charge risk being themselves a source of volatility for financial positions of insurers. The 3 year averaging period by contrast remains stable at -10% over this period, reflecting the long-term trend in a manner more appropriate to the long-term business model of insurers. Sustained structural changes in the level of the market are however clearly reflected as can be seen in the turn of the market over the period 1990 to 1991. It can also be seen that the shift in the capital charge for the 3 year averaging period is swift in response to the sharp fall at the start of 1990, providing immediate capital relief in the face of the sharp fall in the market. This demonstrates that risk-sensitivity is retained under the longer averaging period. The Deloitte report also concluded that a longer period would reduce the SCR following a sharp fall in equity by more than would be the case if a shorter period were used. In such circumstances, the probability of an insurer breaching its capital requirements would be reduced, further promoting the aim of counter-cyclical.

Figure 7: symmetric adjustment comparing 1 and 3 year moving averages¹⁰⁷



Ultimately there can be no precise scientific answer to the choice of the averaging period. The choice comes down to the need for striking a balance between risk-sensitivity and avoiding pro-cyclical effects. EIOPA therefore limited the policy options they tested to broad categories rather than spuriously testing every possible timeframe¹⁰⁸. Respondents to a public consultation on this issue welcomed the use of dampener mechanisms in Solvency II¹⁰⁹. While a few public authorities preferred a 12 month dampener, most respondents (including the French and German insurance industry associations and Insurance Europe) supported a longer period of 36 months. Recent impact studies¹¹⁰ have used a symmetric adjustment based on a time period of 36 months. This period of time was considered to be appropriate to ensure that the impact of short-term movements in equity markets is effectively mitigated without losing the risk-sensitivity introduced by Solvency II. The preferred option is therefore option 2.

¹⁰⁷ Based on the 'Topix' index; EIOPA's Advice for Level 2 Implementing Measures on Solvency II: Equity risk sub-module

¹⁰⁸ A 24 month averaging period, for instance, was not specifically analysed

¹⁰⁹ Comments on EIOPA's Advice for L2 Implementing Measures on SII: Equity risk sub-module

¹¹⁰ QIS 5 and the Long-Term Guarantees Impact Assessment, quoted in section 2.2.1

Figure 8: Comparison of policy options against effectiveness, efficiency and coherence

Objectives Policy option	EFFECTIVENESS		EFFICIENCY	COHERENCE
	Promote long-term investment	Improve the risk-sensitivity of the prudential regime		
Option 1 (baseline): exactly 12 months	0	0	0	0
Option 3: more than 12 months (36 months)	+	≈	+	+

Figure 9: Comparison of the impact of policy options on stakeholders

Stakeholder Policy option	Policy holder protection	Insurance Undertakings	SMEs	Member States / Supervisors
Option 1 (baseline): exactly 12 months	0	0	0	0
Option 2: more than 12 months (36 months)	≈	+	+	≈

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

Avoiding too much volatility in the capital requirement for equity risk by using a longer averaging period (option 2) will help insurers adopt a more long-term perspective in their investment decisions, and will therefore help the general economy in particular SMEs benefiting from funding through private equity funds.

5.3. Adequate requirements regarding the composition of insurers' own funds

As outlined in section 3.3.3 above, the Directive sets quantitative requirements regarding the proportions of the SCR and MCR that must be covered by own funds of tiers 1, 2 and 3. Specifically, it requires that:

- at least half of the MCR must be met with tier 1 own funds¹¹¹;
- 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.

Any amounts of own funds of tiers 2 or 3 in excess of these limits are not eligible for demonstrating solvency, while it is always possible to meet all capital requirements with tier 1 capital, which is the highest quality capital. These levels are minima for eligible own funds; the Directive includes an empowerment for Delegated Acts according to which the Commission shall specify quantitative limits to build on the given minima. The fact that Delegated Acts are mandatory in this area makes it clear that it is the co-legislators' intention that the Delegated Acts go beyond the minima already set out in the Directive.

Quantitative limits that require a high proportion of high quality tier 1 own funds enable insurers to better withstand unexpected losses, thereby retaining the confidence of the market

¹¹¹ Besides, ancillary own funds are not permitted to meet the MCR

and policy holders. The *Sharma report*¹¹² states that the solution in 25% of cases of failing firms was to raise more capital from shareholders, suggesting that the increases were in the form of tier 1 own funds. This reinforces the important role played by tier 1 own funds. The need for the predominant form of eligible own funds to be of high quality is also supported by the G20, Financial Stability Board and the IAIS. The current rules under Solvency I also set out stricter limits on other forms of capital than the minima given in the Directive; they specify that preference share capital and subordinated loan capital may be included, but only up to 50% of the solvency margin¹¹³.

The higher risk associated with tier 1 (equity) capital means that investors on average demand a higher return than for lower tiers, in principle making it a more expensive vehicle for financing from the perspective of the insurer in general. The CRO Forum estimates that the cost of equity is 4% higher than the risk-free rate¹¹⁴, whereas the average cost of debt over a similar period and for a similar credit rating is around half that¹¹⁵. Onerous tier 1 capital requirements could therefore increase the cost of capital, thus risking reducing the profitability of insurers, which could result in increased premiums for policy holders. However, EIOPA's advice¹¹⁶ states that the cost of capital is likely to be higher during times of stressed market conditions or where the insurer needs to restore compliance with its SCR. During the crisis the cost of raising debt capital was around 6.5% higher than the risk-free rate¹¹⁷. Higher limits for tier 1 are likely to reduce the probability of a breach of the SCR, which will avoid the need to raise additional funds at a time when the cost of capital is likely to be higher. Therefore, higher tier 1 limits may in fact serve to reduce the average cost of capital in the long term.

A report by the IMF¹¹⁸ notes that insurers have traditionally had "equity-focused" capital structures. This is supported by the results of QIS5, which indicate that tier 1 own funds excluding hybrids¹¹⁹ account for 92% of available own funds at individual level and 82% of available own funds at group level. QIS5 results also show that overall eligible own funds under Solvency II increase by 27%, as compared to Solvency I, due to the move to a market consistent valuation¹²⁰ of assets and liabilities¹²¹. Since the amounts of tier 1 eligible own funds held by most insurers are considerably higher than those required under the options under consideration, none of the options is likely to increase their cost of capital at the outset of Solvency II.

However, feedback from the Commission's public consultation indicated that mutual insurers

¹¹² The Sharma Report was a study conducted by the EU Insurance Supervisors' Conference in 2002, which looked at the practical lessons that could be learned from EU supervisors' past experience http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/annex-c02_en.pdf

¹¹³ Paragraph 3(a) of Article 27 of Directive 2002/83/EC

¹¹⁴ CRO Forum paper Market Value of Liabilities for Insurance Firms produced in July 2008 available at <http://www.thecroforum.org/assets/files/publications/croforummvlpaperjuly2008.pdf>

¹¹⁵ <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245305949879>

¹¹⁶ See Annex to EIOPA' Advice for Level 2 Implementing Measures on Solvency II: Own funds (https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP46/CEIOPS-L2-Final-Advice-on-Own-Funds-classification-and-eligibility.pdf)

¹¹⁷ Again for an undertaking with a similar credit rating (<http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245305949879>)

¹¹⁸ Op cit

¹¹⁹ Hybrids is the general term to describe preference shares, subordinated liabilities and subordinated mutual member accounts.

¹²⁰ Assets and liabilities are valued at the amount for which they could be exchanged/ transferred between knowledgeable willing parties in an arm's length transaction.

¹²¹ Given that tier 1 own funds consist primarily of the excess of assets over liabilities, changes to the value of assets and liabilities will in most cases result in changes to the level of tier 1 capital

have more restricted access to raising tier 1 own funds in capital markets. Mutual insurers make up approximately 20% of undertakings that will be subject to Solvency II and a proportionally higher number of those insurers classified as small¹²². Stricter limits on tier 1 may for that reason have a more pronounced impact on mutual insurers; but by introducing three tiers of own funds and ancillary own funds, Solvency II significantly broadens the types of own funds that can be used to meet capital requirements. In setting out the limits, it is therefore important that the eligibility limits on tier 2 and tier 3 capital not be so restrictive as to make it impossible for mutuals to recapitalise. A substantial proportion of tier 2 and tier 3 capital should be permitted to avoid this. An alternative could have been to set different lower tiering limits for insurers which are mutuals (or possibly SMEs). This has not however been considered as a realistic policy option since it would effectively mean that a different level of protection would apply to policyholders of different categories of insurers.

The quality of mutuals' own funds was not analysed separately in any of the QIS studies. They were, however, shown to be in a stronger financial position generally than proprietary companies, indicating that it is particularly unlikely for a mutual that any of the options will increase their cost of capital at the outset of Solvency II. It is nevertheless still important that the requirements permit them sufficient flexibility to recapitalise where that may be needed in future.

Three options for the eligibility limits were considered, as set out below.

Option 1 (baseline): applying the minimum eligibility limits according to the Directive

This option entails setting the eligibility requirements at the minimum limits prescribed in the Directive. This is the baseline option as it corresponds to the minimum action under the "shall" empowerment to adopt delegated acts.

Option 2: applying stricter limits in respect of SCR coverage only

This option entails setting the eligibility requirements at the minimum limits prescribed in the Directive with respect to coverage of the MCR, while increasing the requirements in respect of coverage of the SCR as follows:

- at least half of the SCR must be met with tier 1, and no more than one quarter can be met with tier 3.

Option 3: applying stricter limits in respect of SCR coverage and MCR coverage

This option entails increasing the eligibility requirements from the minimum limits prescribed in the Directive with respect to coverage of the MCR as well as the SCR as follows:

- at least 80% of the MCR must be met with tier 1 own funds¹²³;
- at least half of the SCR must be met with tier 1, and no more than 15% can be met with tier 3.

Again there is no uniquely correct set of limits that can be analytically determined. The Option 1 is unlikely to require insurers to obtain higher quality capital, given the high level of tier 1 currently held. However, if insurers were to replace existing tier 1 with tiers 2 or 3 to the extent allowed under option 1 this would increase the likelihood of firms failing, thereby putting policy holders at increased risk.

¹²² 75% of mutuals participating in QIS5 are small as compared to 60% on average.

¹²³ Besides, ancillary own funds are not permitted to meet the MCR

Option 1, by retaining the minimum limits set out in the Directive, also fails to reflect the co-legislators' intent in requiring Delegated Acts to reinforce these minima. Only option 3 fully reflects this intention, by setting stronger limits than the minima in respect of both SCR and MCR coverage.

QIS5 tested the approach to limits under policy option 3. The results indicate that 11% of available tier 2 basic own funds were excluded from eligible own funds as a result of the application of the implicit 50% tier 2 limit. A much greater impact was observed in relation to the 15% tier 3 limit which resulted in 43% of available tier 3 basic own funds being excluded from eligible own funds. However, the existence of transitional measures for own funds¹²⁴ means that some of the items classified in tier 3 may in reality be classified as (at least) tier 2 own funds for Solvency 1 compliant instruments during the transitional period, thus reducing the stated impact of the tier 3 limit.

Options 2 and 3 have a potentially negative impact on insurers whose current amounts of tier 1 are insufficient. The QIS5 results suggest that for the insurance sector as a whole this is not generally the case; as indicated above, 92% of available own funds were classified as tier 1 on an individual firm level. The impact of options 2 and 3 could be greater that rely on ancillary own funds to meet their SCR (since these can never be eligible as Tier 1) . However, these ancillary own funds are still permitted up to 50% so the impact is again limited¹²⁵. It is also unlikely that the higher requirements will "bite" for many insurers, since responses to the fourth quantitative impact study showed that only 35 insurers out of 1,366 reported having tier 1 capital levels below one third of SCR¹²⁶. Only 5% of total own funds were reported to be of a quality below tier 1.

In its final advice on the Delegated Acts, EIOPA recommended that the limit structure should be set so as to ensure that:

- in relation to compliance with the SCR, the proportion of tier 1 is greater than the proportion of eligible tier 2 and that the proportion of eligible tier 2 is greater than the proportion of eligible tier 3;
- in relation to compliance with the MCR, the proportion of tier 1 is greater than the proportion of eligible tier 2 basic own funds.

More specifically, EIOPA also recommended that, as far as the compliance with the Solvency Capital Requirement is concerned:

- the proportion of tier 1 items in eligible own funds is at least 50% of the total amount of eligible own funds (a minority of EIOPA members expressed a preference for at least 60%);

¹²⁴ Paragraph 6 of Article 308b of the Directive states that basic own-fund items shall be included in Tier 1 basic own funds for up to 10 years after 1 January 2016, provided those items:

- a) were issued prior to 1 January 2016 or the date of entry into force of the delegated acts, whichever is the earliest;
- b) could, on 31 December 2015, be used to meet the available solvency margin up to 50 % of the solvency margin according to the laws, regulations and administrative provisions which are adopted pursuant to Article 16(3) of Directive 73/239/EEC, Article 1 of Directive 2002/13/EC, Article 27(3) of Directive 2002/83/EC and Article 36(3) of Directive 2005/68/EC;
- c) would not otherwise be classified in Tier 1 or Tier 2 in accordance with Article 94.

¹²⁵ In the responses to EIOPA's consultation received from insurers, none of the insurers claiming that the tier 1 limit should not be increased from a third provided quantitative evidence that the limits set out under option 3 would be problematic.

¹²⁶ The number of insurers with tier 1 levels between a third and a half was not reported.

- the proportion of tier 3 items in eligible own funds is set at a maximum of 15% of the total amount of eligible own funds. This percentage was considered appropriate due to the characteristics relating to the quality of capital required for elements to be included in tier 3.

Option 3 is the preferred option and is the only option that meets the criteria set out by EIOPA in their advice on the delegated acts. Stricter limits mean that supervisors are able to intervene earlier to ensure the financial robustness of the insurer, extending the ladder of supervisory intervention and increasing policyholder protection. In setting out the limits, it is however essential that the eligibility limits on tier 2 and tier 3 capital not be so restrictive as to make it impossible for mutual insurers, who cannot raise ordinary equity (tier 1), to recapitalise. The limit on the required tier 1 capital to cover the SCR should therefore not go above 50% (as suggested by the minority of EIOPA members, who proposed 60%). It is also clear from the various impact studies that the current levels of tier 1 own funds that EU insurers hold are generally considerably higher than the stricter limits specified, meaning that option 3 is unlikely to require firms to raise additional tier 1 capital, except in exceptional cases. Consequently, option 3 was strongly preferred by national supervisory authorities in the public consultation and was specifically endorsed in EIOPA's advice. The limits under option 3 have been stable since they were introduced for the fifth quantitative impact study (QIS5) in 2010.

Option 3 is the most effective in improving risk-sensitivity because it entails a stricter ladder of supervisory intervention. It is also very efficient, since it is not likely to be very costly (it will not force many insurers to raise new tier 1 capital, as discussed above). It is also coherent with the policy in other financial sectors, since improving the quality of own funds has been high on the G20 and FSB agenda to improve resilience of financial institutions.

Figure 10: Comparison of policy options against effectiveness, efficiency and coherence

Objectives	EFFECTIVENESS: improve the risk sensitivity of the prudential regime	EFFICIENCY	COHERENCE
Policy option			
Option 1: Directive limits (baseline)	0	0	0
Option 2: Stricter SCR limits	+	++	+
Option 3: Stricter SCR/ MCR limits	++	++	++

Figure 11: Comparison of the impact of policy options on stakeholders

Stakeholders	Policyholder protection	Undertakings	SMEs	Member States / Supervisors
Policy option				
Option 1: Directive limits (baseline)	0	0	0	0
Option 2: Stricter SCR limits	+	-	≈	+
Option 3: Stricter SCR/ MCR limits	++	-	≈	++

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

Imposing stricter limits is obviously very positive in terms of policyholder protection, and more demanding as regards impact on insurance undertakings (hence the slightly negative impact in the table above). But the impact on insurance undertakings of option 3 will not be more detrimental than option 2 since quantitative impact studies mentioned above showed that the vast majority of insurers' own funds are already tier 1.

5.4. Risk alignment and transparency of remuneration practices

In achieving the objective of aligning remuneration practices with sound risk management and of making them more transparent, the measures taken in the banking sector require financial institutions to adopt a written remuneration policy under the oversight of a remuneration committee¹²⁷. Similar provisions have been included in the UCITS Directive. CRD IV goes further by also setting quantitative limits on permissible forms of remuneration.

The Green Paper on Corporate governance in financial institutions and remuneration policies, adopted in 2010, explicitly calls for legislative measures in the insurance sector similar to those in the banking sector¹²⁸. It is true that remuneration issues are not identical in the two sectors. In contrast to certain areas of banking, the remuneration of insurance executives is generally not tied to the performance of particular investment funds. The investment strategies of the two sectors also tend to differ: life insurers in particular are less focused on short-term profits, instead focussing their investment strategies on matching guaranteed liabilities and offering long-term returns to policyholders. Nevertheless, in the current low-interest-rate macroeconomic environment which puts insurers under pressure to generate financial returns, it is crucial that the system of governance mitigates the "hunt for yield" in insurers' investment behaviours (see section 3.3.1). In addition, the Commission recommended in 2009 that the actuarial function, in charge of calculating an insurance company's technical provisions, should not be remunerated according to the company's financial performance¹²⁹. Sound remuneration policies are therefore necessary, in insurance undertakings too.

The Solvency II Directive empowers the Commission to specify the elements of the system of governance including a non-exhaustive list of written policies¹³⁰: on this basis, the Delegated Acts can therefore require a remuneration policy. However, the Delegated Acts for Solvency II therefore cannot go as far as CRD IV in imposing quantitative limits on remuneration, since this would require a specific empowerment in the Directive.

In the public consultation that fed into EIOPA's advice on remuneration¹³¹, respondents generally favoured limiting the provisions on remuneration to high level principles requiring that remuneration is considered as part of the good risk management of the business¹³². Many also expressed the view that a complete alignment with banking rules is unwarranted since most of the problems in this area are centred on parts of the banking industry and that there have not been significant problems regarding remuneration within insurers.

The following options are considered:

Option 1 – the delegated acts contain no provisions on remuneration (baseline scenario);

¹²⁷ See Articles 74, 75 and 95 of Directive 2013/36/EU (CRD IV)

¹²⁸ See section 5.7 of COM(2010) 284 final.

¹²⁹ See paragraph 6.6 of Recommendation 2009/384/EC.

¹³⁰ Article 41(3) of the Directive, which is in the scope of the empowerment for delegated acts in article 50(1).

¹³¹ https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP59/CEIOPS-DOC-51-09%20L2-Advice-Remuneration-Issues.pdf

¹³² The contributors consisted exclusively of insurance companies and professional associations

Option 2 – the delegated acts require a remuneration policy to be approved by the administrative, management or supervisory body of insurers, the principles of which must be publicly disclosed along with information on the individual and collective performance criteria and with a description of the main characteristics of supplementary pension or early retirement schemes for key managers¹³³;

Option 3 – the delegated acts require a remuneration policy, which would be disclosed entirely, along with the actual remuneration for key managers.

Option 1 would not be appropriate in the light of the more demanding requirements in other financial sectors. CRD IV and UCITS, for instance, all contain provisions on remuneration. This reflects the wishes of the European Parliament in particular, who are likely to want to see similar provisions for Solvency II. Option 1 would also be inconsistent with the Commission recommendation on remuneration policies in the financial sector¹³⁴, which states that relevant information on the remuneration policy should be disclosed, and with the Commission announcement in the Green Paper on Corporate governance in financial institutions and remuneration policies, which explicitly calls for legislative measures in the insurance sector similar to those in the banking sector.

Option 2 requires insurers to set out their remuneration policy, from which interested parties can determine whether or not the extent of incentives is appropriate. Option 2 has been accepted by Member States in the expert group since 2011. It is consistent with the Green Paper on Corporate governance and with the Commission Recommendation on remuneration policies in the financial sector, which specifies that the 'disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements or any other form'. Public disclosure, as opposed to reporting to supervisors only, is necessary to achieve the transparency and market discipline objectives.

Nevertheless, the disclosure of the full text of the remuneration policy and the addition of the actual remuneration of key managers as prescribed under option 3 would not be of any greater value to the public, who would only wish to ensure the absence of perverse risk management incentives of a systematic nature. The requirements under options 3 therefore do not appear to be proportionate for the insurance industry (this option is therefore considered less efficient). The preferred option is therefore option 2. The sound governance and transparency that it will foster will be equally beneficial for all insurers (whatever their size) while costs are likely to be negligible¹³⁵.

Option 2 has been the preferred option, consensual with Member States and Parliament observers in the expert group, since 2011 (before the Omnibus II negotiations delayed the process).

Figure 12: Comparison of policy options against effectiveness, efficiency and coherence

¹³³ The members of the administrative, management or supervisory body of the undertaking, who according to Article 40 of the Directive, have 'the ultimate responsibility for the compliance, by the undertaking concerned, with the laws, regulations and administrative provisions adopted pursuant to this Directive'.

¹³⁴ Recommendation 2009/384/EC

¹³⁵ The Delegated Acts do not require insurers to maintain additional, dedicated resources to design and implement the remuneration policy. This is a task for the existing administrative, management or supervisory body of each undertaking. In addition, the disclosure requirement will only add one section to the annual Solvency and Financial Condition Report, already required by the Directive.

Objectives Policy option	EFFECTIVENESS:		EFFICIENCY	COHERENCE
	Risk alignment	Transparency		
Option 1 (baseline)	0	0	0	0
Option 2	+	+	+	+
Option 3	+	++	-	-

Figure 13: Comparison of the impact of policy options on stakeholders

	Policyholder protection	Insurance Undertakings	SME insurers	Member States/NSAs
Option 1 (baseline)	0	0	0	0
Option 2	+	+	+	+
Option 3	+	≈	≈	+

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

5.5. Harmonised and proportionate requirements on valuation

The Directive requires insurers to value their assets and liabilities in a market-consistent manner for the purpose of determining their solvency position, namely at an amount for which they would be traded by knowledgeable, willing parties in an arm's length transaction. It is left to the Delegated Acts to determine to what extent this high-level principle should be translated into detailed accounting principles. The Directive does not require the use of specific accounting standards or methods, and leaves it to the Delegated Acts to set out if and how they should be used. As the Directive requires that Solvency II valuation be market consistent, and the local GAAP in many Member States are based on principles that are not (e.g. prudence), relying on local GAAP methods solely is not an option that can be seriously considered. Many IFRS standards however have been developed based on market-consistent valuation principles. Consistently, the Directive recognises the IFRS standards¹³⁶ as a natural reference, by requiring the delegated acts to specify to what extent the IFRS are consistent with the market-consistent valuation approach.

On the question to what extent the use of IFRS for the purpose of Solvency II valuation should be required, the following options are considered:

Option 1: Require all insurers to use IFRS for solvency purposes wherever IFRS provides for market-consistent valuation principles;

Option 2: Require insurers that use IFRS for their financial statements to use IFRS for solvency purposes wherever IFRS provides for market-consistent valuation principles, but allow for alternative market-consistent valuation methods for other firms in cases where using IFRS would be unduly burdensome;

Option 3 (baseline): Do not require the use of a specific accounting framework (IFRS) for Solvency II and provide high-level principles for market-consistent valuation only:

¹³⁶ which have been endorsed by the European Commission in Regulation 1606/2002

Option 3 can be considered as the baseline option, under which the Delegated Acts would not refer to specific accounting standards, but instead would only provide high level principles on market-consistent valuation. Whilst these could be based for example on general principles for recognition and valuation borrowed from IFRS,¹³⁷ they would not require the use of the more detailed rules set out in the accounting standards. This would give undertakings a great degree of freedom with regard to the choice of valuation methods, which would pose a challenge to supervisors, who, for the purpose of assessing the compliance with the general principles, would need to provide a full audit of the Solvency II valuation. This would introduce a new supervisory task of a considerable dimension¹³⁸ and impose significant costs on the insurer, which typically bears the cost of this audit. Also, this option does not satisfy the objective of supervisory convergence, especially in the context of insurance groups, where the group supervisor could be confronted with different accounting practices in different entities within the group.

In contrast to this, option 1 provides for harmonization of Solvency II valuation to the maximum extent possible, by requiring the use of IFRS for solvency purposes wherever IFRS provides for market-consistent valuation principles. It should be noted that this does not mean that IFRS can be used in any instance, because certain IFRS standards deviate from market-consistent principles set out by the Directive, for example by allowing for methods based on amortized cost. Under option 1, general IFRS valuation principles¹³⁹ are set out and complemented by the requirement to use IFRS standards wherever they comply with these principles. Whilst option 1 ensures maximum convergence (therefore helping convergence of supervisory practices as well), it also imposes a high burden on undertakings that do not use IFRS to prepare their financial statements, because they are forced to build up capacities for the preparation of an alternative balance sheet valuation. This would be the case for most insurers within the Union, since in the Union only listed companies are required to use IFRS for their consolidated accounts.¹⁴⁰

In many Member States, the local GAAP provide for market consistent valuation to a similar degree as IFRS does. Under option 2 these can be used, as it allows undertakings that do not prepare IFRS financial statements for disclosure purposes to use alternative market-consistent methods. Option 2 is also consistent with EIOPA's advice on Solvency II valuation, which stated that the adoption of IFRS as a reference framework for the determination of the economic valuation should not interfere with the set of accounting principles, standards and procedures that undertakings are allowed to use when preparing their financial statements.¹⁴¹ Whilst option 2 provides for less convergence than option 1, it still ensures a high degree of comparability between Solvency II valuations by maintaining IFRS as a reference framework. Thus, it is also costly than option 3 and is the most efficient option.

Option 2 is the preferred option. It strikes an optimal balance between harmonisation and proportionality considerations, by basing the valuation framework on a generally accepted

¹³⁷ e.g. the introduction of a valuation hierarchy in accordance with IFRS 13

¹³⁸ Under Solvency I, the supervisor is not required to audit the balance sheet, since the solvency position is determined based on the financial statements of the undertakings, which by law need to be audited by a professional auditor.

¹³⁹ From IFRS 13

¹⁴⁰ For an overview to which extent Member States choose to top this requirement in their national legislation see here: http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options2010_en.pdf

¹⁴¹ EIOPA's Advice for Level 2 Implementing Measures on Solvency II: Valuation of Assets and Other Liabilities; October 2009 (https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP35/CEIOPS-L2-Final-Advice-on-Valuation-of-Assets-and-Other-Liabilities.pdf)

standard, but allowing for deviations where this would be too costly and burdensome. These deviations however should be strictly aligned with the Directive's general requirements on market consistent valuation. In addition, since option 2 opens the valuation framework to a certain degree of methodological divergence, there should be sufficient safeguards ensuring supervisory control. Thus, the exemption from IFRS should be accompanied by requirements that insurers demonstrate that the use of IFRS would be overly costly, including with numerical arguments, as part of their reporting to supervisors..

Figure 14: Comparison of policy options against effectiveness, efficiency and coherence

Objectives Policy option	EFFECTIVENESS:		EFFICIENCY	COHERENCE
	Harmonisation	Proportionality		
Option 1	++	--	+	+
Option 2	+	≈	++	+
Option 3 (baseline)	0	0	0	0

Figure 15: Comparison of the impact of policy options on stakeholders

	Policyholder protection	Insurance Undertakings	SME insurers	National supervisory authorities
Option 1	+	-	--	+
Option 2	+	≈-	+	-≈
Option 3 (baseline)	0	0	0	0

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

5.6. Harmonized and proportionate requirements on supervisory reporting¹⁴²

The Directive makes a distinction between the information that has to be reported to supervisors and information that has to be disclosed to the public.

It introduces the "Solvency and Financial Condition Report" (SFCR) as the vehicle for public disclosure. The SFCR shall be published annually and its content is outlined in the directive (covering business and performance, system of governance, risk profile, valuation for solvency purposes and capital management)¹⁴³.

As regards supervisory reporting, the Directive gives more flexibility in the Delegated Acts which must specify the nature and the frequency of each piece of the information to be

¹⁴² This chapter makes extensive use of EIOPA's advice on supervisory reporting and disclosure (https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP58/CEIOPS-L2-Final-Advice-Supervisory-Reporting-and-Disclosure.pdf). This advice took into account comments from more than 40 stakeholders received in a public consultation, the industry, institutes of actuaries, and audit firms (https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP58/CEIOPS-SEC-121-09_Comments_and_Resolutions_Template_on_CEIOPS-58-09.pdf).

¹⁴³ See article 51 of the Directive.

reported to supervisors (possibly shorter than yearly). However, the actual content of these documents is not fixed in the Delegated Acts but by EIOPA, which is empowered by the Directive to develop reporting templates via implementing technical standards¹⁴⁴.

The analysis of regularly reported data is the cornerstone of financial supervision. An adequate level of detail and frequency is necessary to achieve convergence of supervisory practices, reducing the need for *ad hoc* requests whenever the standardised European formats do not provide enough up-to-date information to understand the risks to which the insurer is exposed when a crisis hits.

The information needs of supervisors are more acute than those of the public.

In particular, frequency of reporting to supervisory authorities is also crucial since the recent financial crisis has proven that up-to-date information is critical to rapidly assess the impact on insurers' financial position of any significant adverse unexpected event, without burdening the undertakings with *ad-hoc*, unpredictable information requests when a crisis hits (as explained in section 3.4).

However, increasing excessively the frequency of reporting could have adverse effects both for insurers – especially those which are SMEs - and for the supervisors that would have to dedicate disproportionate resources to process the information¹⁴⁵. Data warehousing and its evaluation is a complex and costly business not only for the supervisors but also for insurers that have to produce the required information. The cost of implementation of full quarterly reporting was estimated, considering the difficulties and uncertainties of this kind of valuations, to lie within a range of €mn418-696 for the insurance sector¹⁴⁶ and the on-going costs around €38mn per year¹⁴⁷.

Supervisory reporting requirements should strike an appropriate balance between proportionality and harmonisation of the information, some of which is necessary on a more frequent basis than the annual basis for public reporting.

In light of the above, three options are set out below:

Option 1 (baseline): All elements of the supervisory reporting (a report along with quantitative templates) should be submitted only annually, as the public report (SFCR).

Option 2: A Regular Supervisory Report (RSR) should be reported annually, along with quantitative templates. In addition, a *limited subset* of templates ("core quantitative data") should be provided quarterly.

Option 3: Same option than option 2 but *all* quantitative templates should be reported quarterly, while the report only is submitted annually.

Any decision about how often the information should be submitted must take into account not only the cost and the ability of insurers to produce the quantity of data in time, with the proper

¹⁴⁴ See article 35(10)

¹⁴⁵ EIOPA's Advice for Level 2 on Supervisory Reporting and Public Disclosure Requirements, 3.640 p. 150 https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP58/CEIOPS-L2-Final-Advice-Supervisory-Reporting-and-Disclosure.pdf

¹⁴⁶ External Study by Deloitte for the Impact Assessment of Solvency II, 2010, p.347

¹⁴⁷ External Study by Deloitte for the Impact Assessment of Solvency II, 2010, p.337

quality standards, but also the ability of supervisors to use the information within their supervisory review process in a timely manner.

Full quarterly reporting of the whole package (option 3) would require upgrading capital and reserving models to deliver new requirements (e.g. for MCR, SCR, technical provisions or own funds), building new data processes to deliver the information on a timely basis, familiarization with the new requirements, and staff and board training.

Some of the information to be reported annually is calculated considering a time horizon of one year. That is the case of the SCR, which are based on a one year 99.5% VaR level of confidence. Requiring its calculation every quarter would not have a significant added value but would be very burdensome for insurers.

In its advice, EIOPA estimated that the whole package of information being requested on a quarterly basis (option 3) was likely to be around four times as costly as requesting it on an annually basis (option 1)¹⁴⁸.

However, with option 1 the efficiency of the supervisory task would suffer, as would convergence, because supervisors would need to supplement such an insufficient reporting with a considerable amount of additional *ad hoc* requests, leaving room for divergent supervisory practices in the Union, burdening all undertakings.

Option 2 is considered to be the one that better meets the objectives of enhancing supervisory reporting convergence, transparency and proportionality, preventing excessive burden for the (re)insurance undertakings and the supervisory authorities.

This option is also in line with EIOPA advice to the Commission on Supervisory Reporting to provide only the basic information quarterly which is preferable to too much information too frequently, preventing overloading the supervisory authorities with too much data.¹⁴⁹

Under the terms of the Omnibus II Directive it falls on EIOPA to actually develop the reporting templates, in the form of implementing technical standards. In accordance with Article 15 of Regulation (EU) No 1094/2010, the Commission will decide on whether to adopt the draft implementing technical standard, ensuring that the amount and complexity of quarterly reporting templates is limited to what is strictly necessary for supervisory needs.

Choosing option 2, whereby quarterly reporting is only limited to a subset of core quantitative data, means that the cost estimation by Deloitte already overestimates the actual cost of the preferred option. In addition, two safeguards were included in the Directive by Omnibus II (after the Deloitte estimation) to avoid overburdening undertakings and supervisors with reporting:

- Article 35, paragraphs (6) to (8), gives national supervisors the power to alleviate reporting that is required on a frequency shorter than one year, for smaller and less complex undertakings representing less than 20% of their national market;

¹⁴⁸ EIOPA's Advice for Level 2 on Supervisory Reporting and Public Disclosure Requirements, p. 149 https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP58/CEIOPS-L2-Final-Advice-Supervisory-Reporting-and-Disclosure.pdf

¹⁴⁹ EIOPA's Advice for Level 2 on Supervisory Reporting and Public Disclosure Requirements, p. 160 (point 3.680) https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP58/CEIOPS-L2-Final-Advice-Supervisory-Reporting-and-Disclosure.pdf

- Article 308b, paragraphs 6 to 8, set out a phasing-in period whereby deadlines for submission are extended by several weeks in the first 4 years of application.

The impact of the three policy options on stakeholders is summarised below. Option 3, would be excessively burdensome, not only for insurers (except SME insurers, which can benefit from the exemptions from quarterly reporting laid down in the Directive anyway) but also for supervisors, who would be flooded with reporting from undertakings in their jurisdiction. This means option 3 would be counterproductive, hampering policyholder protection by wasting or distracting supervisory resources. Option 2, strikes the best balance, limiting the administrative burden on insurers to the minimum necessary, while allowing supervisors to carry out their task efficiently on the basis of harmonised information from undertakings.

Figure 16: Comparison of policy options against effectiveness, efficiency and coherence

Objectives Policy option	EFFECTIVENESS		EFFICIENCY	COHERENCE
	Harmonised requirements (supervisory convergence)	Proportionate requirements		
Option 1 (baseline)	0	0	0	0
Option 2	+	≈	+	+
Option 3	++	-	-	-

Figure 17: Comparison of the impact of policy options on stakeholders

	Policyholder protection	Insurance Undertakings	SME insurers	Supervisory authorities
Option 1 (baseline)	0	0	0	0
Option 2	++	-	≈	+
Option 3	-	--	≈	-

Ranging from a very positive impact (++) to neutral (≈) and very negative impact (--)

6. OVERALL IMPACTS OF THE PACKAGE

This Section summarises the preferred options and presents the predicted costs and benefits of the entire package of preferred options.

Figure 18: Overview of the operational objectives and preferred options

Operational objective	Preferred option
Operational objective 1: Sound relative calibration of capital requirements, and other measures, on long term investments	Option 4: an approach based on the standard formula, taking into account the latest EIOPA report on the design and calibration of capital requirements, but going further with several modifications to enhance long-term investment by insurers and ensure consistency with other policy initiatives, while respecting the 99.5% VaR metric defined in the directive. On the counter-cyclical mechanism for equity capital requirements, option 2: determine the market level relative to a period of 36 months
Operational objective 2: Adequate requirements	Option 3: applying stricter limits than the minimum

regarding the composition of insurers' own funds	laid down in the Directive in respect of both SCR coverage and MCR coverage (at least 80% of the MCR must be met with tier 1; at least half of the SCR must be met with tier 1, no more than half with tier 2 and 3 together, and no more than 15% can be met with tier 3)
Operational objective 3: Risk alignment and transparency of remuneration practices	Option 2: require a remuneration policy, the <u>principles</u> of which must be publicly disclosed along with information on the individual and collective performance criteria and with a description of the main characteristics of supplementary pension or early retirement schemes for key managers
Operational objective 4: harmonised and proportionate requirements on valuation of assets and liabilities	Option 2: Require insurers that use IFRS for their financial statements to use IFRS for solvency purposes wherever IFRS provides for market-consistent valuation principles, but allow for alternative market-consistent valuation methods based on local accounting standards in cases where using IFRS would be unduly burdensome and costly.
Operational objective 5: Harmonized and proportionate requirements on reporting	Option 2: require insurers to submit a regular supervisory report and quantitative reporting templates annually, with only a subset of core quantitative templates to be submitted quarterly. The proportionality exemptions laid down in the Directive can apply to both types of templates.

6.1. Economic benefits

6.1.1. Benefits for consumers

Consumers of insurance products will benefit from stable and secure insurance undertakings capable of meeting their commitments, as a result of all the measures considered herein, especially the enhanced requirements on composition of own funds and the risk sensitivity of the calibrations for asset categories. The long-term investment-related measures should mitigate the attested excessive cautiousness of insurers when choosing assets in which to invest, with a positive impact on returns, to the benefit of policyholders, especially of life insurance. The public report (SFCR), while unlikely to be read by numerous policyholders directly, can be used by insurance brokers in advising consumers on the choice of an insurer, and will be used by analysts to advise consumers of investment products on the advisability of investing in an insurer.

6.1.2. Benefits for undertakings

For the purposes of this section, undertakings must be divided into three categories: insurance undertakings, undertakings into which insurers may directly or indirectly invest, and undertakings which may be policyholders of insurance policies (this latter category can be considered as consumers for this purpose, and the points made above in section 6.3.1. apply).

Undertakings as potential investees of insurers will benefit from the equity dampener, with its calibrations as determined in section 5.2 above, and from the long-term investment measures described in section 5.1 above.

For insurance undertakings, the benefits must be considered in the context of the entire Solvency II Directive, including the long-term guarantee package introduced by Omnibus II. The principal benefit is reduced likelihood of failure of an insurer through enhanced prudential requirements, and the imposing of capital standards corresponding to 99.5% value

at risk over a 1 year time horizon, which is imposed by the Directive, and respected in the long-term investment choices described herein. The enhanced requirements on composition of own funds are also important in achieving this benefit. The calibrations on capital requirements for assets are designed to achieve a more efficient allocation of capital and greater returns, as mentioned above in 6.1.1. In addition, the disclosure of the principles of the remuneration policy will impose market discipline and promote sound risk management, avoiding excessive risk taking.

6.1.3. Benefits for SMEs

The analysis for SMEs must be divided into the same three categories as the previous section. Regarding SMEs which are holders of insurance policies (consumers), the benefits are no different from those for undertakings in general, including larger undertakings. Regarding SMEs as potential beneficiaries of investment from insurers, in particular the placing of European Venture Capital Funds, and European Socially Responsible Investment Funds in the least onerous of the equity buckets, as well as other private equity funds, will stimulate investment by insurers in SMEs (though the extent of this effect will naturally depend on the success of those investment vehicles themselves); also, securitised SME loans can qualify for the "high quality securitisation" label in a lower risk bucket than other securitisations if they meet transparency and simplicity requirements proposed by EIOPA, inspired from the European Central Bank eligibility criteria for collateral, and welcomed by the market. Regarding insurance undertakings which are SMEs, the possibility for insurers to use accounting standards other than IFRS for the purposes of valuation of assets is an important proportionality element in the selected measures, which will be used largely by smaller insurers.

6.1.4. Impact on Member States/Supervisors

The main impact on member States' supervisors of the measures considered in this impact assessment falls in the area of transparency and reporting. As a result of the harmonisation of the requirements for reporting to supervisors, some supervisors may not receive the same information or not with the same frequency as hitherto. However, the harmonisation will improve comparability of information between supervisors and facilitate the functioning of colleges of supervisors.

6.1.5. Impact on EU budget

The Delegated Acts have no impact on the EU budget.

6.2. Social benefits

The social benefits of the measures essentially flow from the macro-economic benefits, as described in 6.5 below.

6.3. Environmental benefits

The proposed action is not expected to have any significant positive or negative environmental impact.

6.4. Administrative burden

The administrative burden on insurance undertakings arises essentially from the Directive, and must be offset against the increased stability which will result from enhanced prudential rules. The administrative burden could have been reduced to a minimum by opting for

reporting annually only, but as discussed in section 5.6, the intermediate option of reporting only core data quarterly balances administrative cost with the need for more frequent supervisory information, which is essential to ensure timely intervention and avoid the burden of *ad hoc* divergent and unpredictable enquiries from supervisors when a crisis hits. In addition, the administrative burden from reporting will be further mitigated by the fact that the Directive gives supervisors the power to alleviate the quarterly reporting requirements for smaller insurers and provides for a phasing-in of submission deadlines, which are extended in the first four years of application (see section 5.6). The requirement for a remuneration policy will only cause negligible administrative cost since the requirements amount to adding only one section in the annual public report already required by the Directive. No dedicated resources are required since the remuneration committee adopting the remuneration policy is made up of existing members of the administrative, management or supervisory body. In contrast, the benefits in terms of governance and better risk management will largely outweigh this.

6.5. Macro-economic impact

The macro-economic impact of the measures will be twofold. First, the economic stability and growth which will arise from improved prudential soundness of the insurance sector: failures of insurers can be highly costly and disruptive, and the choice to require more higher-quality capital than the minimum laid down in the Directive will alleviate this risk. Second, there will be more investment in the real economy. The volume of funds which is available for investment by the insurance sector is such (€8,400bn, see section 3.3.1. above) that if even a very small proportion of it is reallocated into more growth-enhancing investments as a result of the long-term investment measures in the Delegated Acts, the potential impact on growth and employment is significant.

6.6. Impact on third countries

The measures considered in this impact assessment have only marginal and indirect effects on third countries (via EU subsidiaries of third country insurers for example). For completeness, it should be mentioned that the Delegated Acts also contain detailed criteria for the determination of equivalence of third countries (see the list of empowerments in Annex 2), but these closely reflect the provisions of the relevant articles of Solvency II (172, 227 and 260), as modified by the "Omnibus II" Directive, and the margin for the exercise of discretion by the Commission in the Delegated Acts was too limited to warrant inclusion in this impact assessment.

6.7. Overview of benefits and costs

The costs of the choices exercised by the Commission described in this impact assessment fall almost entirely on insurance undertakings and arise essentially from the reporting requirements and possibly the requirement on the quality of own funds. The benefits, while accruing partly to insurance undertakings in terms of the reduced likelihood of failure, also impact society more widely. This includes the benefits from increased stability of the insurance sector, greater availability of insurance and greater investment in growth-enhancing sectors. These benefits are considered to considerably outweigh the limited costs, both of which are outlined in more detail below for each of the options.

Overall, the options in the Delegated Acts have a much smaller impact than other policy issues settled in the Directive, e.g. the impact of the long-term guarantees package introduced

by Omnibus II which provided capital relief of €245bn for the EU life market alone¹⁵⁰. In comparison, the order of magnitude of the cost impact of the current options is around or less than one billion euros (with the largest part being the one-off implementation cost of supervisory reporting, as discussed in section 5.6).

Long-term investments

Costs: Lower capital charges are applicable to the assets the Commission wishes to stimulate, meaning the selected option is likely to lead to lower capital costs for insurers on aggregate. The increased granularity of the capital charges means that the complexity is also increased; but this effect is rather minor and is unlikely to lead to a change in operational costs.

The requirements under options 3 and 4 also add complexity to the capital calculations for securitisations since it will be necessary for insurers to check whether each instrument complies with the high-quality criteria. However, the purpose of the high quality distinction is precisely to stimulate investment into simpler securitisation products. On balance the expected effect will therefore be to reduce the overall complexity of the financial system and consequently to reduce the operational costs associated with the management of complex risks. Any temporary increase in the complexity of capital calculations for securitisations will also be more limited for SMEs, since they are traditionally not heavily invested in securitisations due to the prohibitive costs of the expertise required. While the high-quality securitisation distinction therefore targets larger insurers, even the 13 largest groups, accounting for half of total investments, only held 53bn€ in securitisation (2% of their portfolio) as of end 2011, only a portion of which would qualify as high-quality and therefore be eligible for the lower proposed charges. These market players in any case have more complex risk management systems in place, thus the cost impact is very limited indeed.

The selected option is expected to have a positive impact on the variety and prices of insurance products, since the long-term investment perspective it fosters will reduce capital and possibly operation costs, to the benefit of investment and retirement savings products in particular.

Benefits: the sound relative calibration of the capital requirements on long-term investments set out under the proposed option ensures that there are no undue capital impediments to insurers investing in asset classes that support growth in Europe. This is consistent with the specific objective of promoting long-term investment and the general objective of fostering growth and recovery in Europe.

Capital requirements that are more closely tailored to the specific risks faced by insurers when investing in these assets also improve the risk sensitivity of the prudential framework and thereby enhance policyholder protection. The lower capital charges for high-quality securitisations, for instance, create an incentive for insurers to invest in simpler securitisations that are of a higher quality.

Equity risk dampener

Costs: using a longer averaging period (3 years and not 1 year) will help insurers adopt a more long-term perspective in their investment decisions, helping to stabilise the general economy including SME financing, since SMEs benefit from funding through private equity funds that will be subject to the dampener.

¹⁵⁰ EIOPA's report on the long-term guarantees impact assessment showed a capital shortfall of around €245bn in the absence of any long-term guarantees measures (see section 2 of the report: https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/OIS/Preparatory_forthcoming_assessments/final/outcome/EIOPA_LTGA_Report_14_June_2013_01.pdf)

Benefits: a 3-year averaging period means that the equity capital charge will be more stable and less susceptible to short-term price movements that are not sustained. The countercyclical impact of the adjustment on the financial position of insurers reduces the incentive to sell off assets when markets are stressed and the overall short-term volatility associated with equities. This serves to promote long-term investment in equities and the general objective of fostering growth and recovery in Europe.

Remuneration

Costs: the costs of the option chosen are negligible, since the requirements amount to adding only one section in the annual public report already required by the Directive. No dedicated resources are required since the remuneration committee adopting the remuneration policy is made up of existing members of the administrative, management or supervisory body.

Benefits: the requirement for insurers to set out their remuneration policy allows interested parties to determine whether or not the extent of incentives is appropriate. This is consistent with the Green Paper on Corporate governance, the Commission Recommendation on remuneration policies in the financial sector and the objective of deepening the integration of the insurance market by increasing transparency.

Own funds tiering

Costs: requiring more tier 1 capital may increase the cost of holding regulatory capital. However the impact and cost at the start date of Solvency II of increasing the requirements is very limited: responses to the fourth quantitative impact study showed that only 35 insurers out of 1,366 reported having tier 1 capital levels below one third of SCR. Only 5% of total own funds were reported to be of a quality below tier 1; and the results of QIS5 indicated that tier 1 own funds excluding hybrids¹⁵¹ account for 92% of available own funds at individual level. The existence of transitional measures (in Omnibus II) for the classification of own funds means that some of the items classified in tier 3 may in reality be classified as tier 1 own funds for Solvency I compliant instruments during the transitional period, further reducing the stated impact of the limit.

The quality of mutuals' own funds was not analysed separately in any of the QIS studies. They were, however, shown to be in a stronger financial position generally than proprietary companies, indicating that it is particularly unlikely for a mutual that any of the options will increase their cost of capital at the outset of Solvency II. It is nevertheless still important that the requirements permit them sufficient flexibility to recapitalise where that may be needed in future.

Benefits: higher limits for tier 1 are likely to reduce the probability of a breach of the SCR. This increases the financial stability of the insurer, which is good for policyholders; but it also means the insurer avoids the need to raise additional funds at a time when the cost of capital is likely to be higher. Since the ordinary equity capital included in tier 1 is the most loss absorbent, the need for undertakings to raise additional capital when facing an exceptional loss is lowered by the stricter tiering limits. Higher tier 1 limits are therefore in fact expected to reduce the average cost of capital in the long run. They also improve the risk sensitivity of the prudential regime by allowing supervisors to intervene earlier to ensure the robustness of an insurer, increasing the ladder of supervisory intervention and enhancing policyholder protection.

Valuation

¹⁵¹ Hybrids is the general term to describe preference shares, subordinated liabilities and subordinated mutual member accounts.

Costs: the option with minimal costs for insurers has been chosen. The option chosen is the most cost-effective for SME's, as it allows the use of local GAAP to the maximum extent possible within the framework set by the Directive (which demands market-consistent valuation). The requirement to use IFRS as a framework for valuation is motivated by convergence considerations and will not increase the costs for SME's as they are allowed to deviate from it when local GAAP is market consistent. Large insurance groups are likely to use IFRS for their financial statements anyway, as this is a legal requirement for listed companies.

Benefits: the benefits for this option stem from a reduction in cost. The preferred option strikes a balance between harmonisation and proportionality considerations by basing the valuation framework on a generally accepted standard, but allowing for deviations where this would be too burdensome.

Only the option on reporting is likely to have a material cost impact.

Reporting

Costs: according to the Deloitte report, the estimate to implement full quarterly reporting is a one-off cost in the range €418mn-696mn. These one-off costs, and the on-going annual cost of €38mn, should be compared to the total annual premium income of European insurers, which was around €1,100bn in 2012 (see section 3.1.1). The cost for the option chosen – to require only a limited set of information on a quarterly basis – means that these figures are still overestimations. Under Omnibus II empowerments, it will be up to EIOPA to concretely define the limited set in Implementing Technical Standards, with the Commission checking whether the scope of the quarterly templates is indeed limited to the minimum necessary when adopting the draft Implementing Technical Standards.

Costs linked to quarterly reporting are further mitigated by the fact that Omnibus II introduces more flexibility to national supervisory authorities to exempt smaller insurers from quarterly reporting for up to 20% of the market volume.

Benefits: the objectives are to enhance supervisory reporting convergence and transparency, in a way that is proportionate and prevents creating an excessive burden for (re)insurers. The preferred option of allowing a limited subset of templates to be reported quarterly, while the full set are reported annually, strikes the best balance between these objectives.

Figure 19: Summary of the impact of the preferred proposals on various stakeholders

	Policyholders	Undertakings	SMEs	Member States/NSAs
BENEFITS				
Economic benefits				
- stability of insurance sector	++	+	+	++
- long-term investment	+	++	++	++
Social benefits				
- stability of insurance sector	++	+	+	++
- long-term investment	+	++	++	++
Environmental benefits	≈	≈	≈	≈
COST				

Administrative costs	0	-	-	≈
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Notes: ranging from a very positive impact (++) to neutral (≈) and very negative impact (--).

7. MONITORING AND EVALUATION

Recital 60 of the Omnibus II Directive indicates that:

"In order to ensure that the Union's objective of long-term sustainable growth, as well as the objectives of this Directive primarily to protect policyholders and also to ensure financial stability, continue to be met, the Commission should review the appropriateness of the methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement standard formula within five years of the application of the Directive. ... The review of the standard parameters for certain asset classes, such as fixed-income securities and long term infrastructure, may need to be prioritised."

The Delegated Acts include a shorter review clause (by the end of 2018) for methods, assumptions and parameters used in the calculation of the Solvency Capital Requirement. Two of the issues discussed in the present impact assessment fall within the scope of that review, namely the risk calibrations applied to different asset classes and the parameters of the equity dampener. This will allow the Commission to adjust calibrations to market developments (including any unexpected or undesirable change in insurers' investment behaviour) and to refine risk factors, as the improvements in market transparency and standardisation of products will increase the availability of market data. For example, as reflected in EIOPA's latest report¹⁵², in discussions with Member States within the expert group and in various contributions from the industry to the Green paper on long-term financing, it is not possible for the moment to come up with a clear-cut, consensual definition of infrastructure assets to be stimulated: this will be reviewed in light of progress made under the aegis of G20¹⁵³.

The review clause also specifically calls for a review of the calculation of non-life underwriting risks (premium and reserve risks), as well as a review of the subset of parameters in the standard formula that can be replaced by undertaking-specific parameters (the Directive allows such USPs, but it is up to the Delegated Acts to prescribe standardised methods to estimate them, thereby constraining the set of parameters that can be undertaking-specific).

In addition, the Delegated Acts set out a process for updating certain parameters set out in the Directive.¹⁵⁴ This process provides that member states collect undertaking-specific data on an annual basis and provide it to EIOPA for the purpose of updating those parameters.

General monitoring of the soundness and stability of the insurance sector in the EU, and of the effect of the regulatory framework, is conferred upon EIOPA according to its founding Regulation. In particular, EIOPA carries out regular stress tests of EU insurers, to calculate their ability to external shocks (such as falls in interest rates or asset values, asset defaults

¹⁵² See pp. 100-103 in EIOPA's report quoted in footnote 94.

¹⁵³ See the communiqué of the G20 Finance Ministers and Governors meeting in Brisbane (April 2014) calling for the creation of a 'global infrastructure facility' to pool resources and data (available on <http://www.g20.org>). See also the initiative to collect statistics on infrastructure assets announced on page 13 of the Commission communication on long-term financing of the European economy.

¹⁵⁴ Namely, the correlation parameters that serve the purpose of integrating different modules of the solvency capital requirement (Annex IV of Directive 2009/138/EC)

etc.). The stress tests are carried out against the background of the legal framework in place, including the Delegated Acts. EIOPA is also obliged to submit an annual report on "trends risks and vulnerabilities within its area of competence"¹⁵⁵, which can include matters arising out of the regulatory framework, and also to consider systemic risks for the insurance sector, and jointly with the European Systemic Risk Board, develop ways of addressing them¹⁵⁶. This work by EIOPA is taken into account by the Commission in evaluating possible changes to the Directive and the Delegated Acts.

¹⁵⁵ Regulation 1084/2010 establishing EIOPA, article 32

¹⁵⁶ Regulation 1084/2010 establishing EIOPA, articles 22-24.

ANNEX 1. OVERVIEW OF THE SOLVENCY II DIRECTIVE (DIRECTIVE 2009/138/EC AS AMENDED BY DIRECTIVE 2014/51/EU)

Supervisory Reporting and Public Disclosure

Supervisory Reporting - under the Directive undertakings are required to submit regular information to supervisory authorities which is necessary for the purposes of supervision.

Public Disclosure - the Directive requires undertakings to disclose annually a report on their solvency and financial condition (SFCR).

Transparency and Accountability - the Directive requires supervisory authorities to conduct their tasks in a transparent and accountable manner with due respect for the protection of confidential information.

System of Governance

The Directive requires undertakings to have in place an effective system of governance which provides for sound and prudent management.

Under the Directive supervisors may grant undertakings that do no longer comply with their SCR the period of a maximum of 6+3 months to remedy the situation. However, should an exceptional fall in financial markets occur the Directive provides for the possibility to further extend this period, up to seven years.

The Directive allows supervisory authorities in exceptional circumstances, and as a measure of last resort, to set a Capital Add-On. These circumstances apply if the supervisory authority concludes that (i) the risk profile of an undertaking deviates significantly from the assumptions underlying the SCR, or (ii) that the system of governance of an undertaking deviates significantly from the relevant standards in the Directive.

Quantitative Requirements

Valuation of assets and liabilities

The Directive sets out the principle that assets and liabilities must be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction ("market consistent valuation").

Technical provisions

The Directive sets out the high level principle that technical provisions for (re)insurance obligations should correspond to the transfer value of the obligations. The Directive specifies the calculation of technical provisions in broad terms, namely technical provisions should be the sum of a best estimate and a risk margin. The risk margin calculation is based on a hypothetical transfer scenario of the (re)insurance obligations to another undertaking.

The Directive also sets out in detail the so-called long-term guarantees measures. The long-term guarantees measures mitigate artificial volatility in the regulatory balance sheet of insurers and reinsurers by partially reflecting movements in asset prices in the market-consistent valuation of the liabilities also, thereby stabilising the aggregate financial position of undertakings. By incorporating the long-term investment strategies of insurers and

reinsurers in the market consistent valuation framework, their long-term ability to meet their cash-flow needs is more accurately captured. There are also measures to ensure a smooth transition to the valuation provisions of Solvency II and to allow for supervisory discretion in exceptional market conditions. The specific measures are outlined below.

- **Matching adjustment:** the matching adjustment is essentially an adjustment to the discount rate applied in the valuation of highly predictable liabilities which are cash-flow matched using fixed income assets. The predictability of the portfolio means that matching assets can be held to maturity and that the insurer is consequently not exposed to price movements unrelated to default, the effect of which is captured by the matching adjustment. The adjustment is equal to the non-default portion of the spread on the backing assets. By applying this adjustment to the discount rate used to value liabilities, the market value of the liabilities moves to partially offset the non default-related changes in asset values. This has the effect of reducing the overall balance-sheet volatility of the insurer. The matching adjustment can turn negative in periods of market exuberance, in which case the effect would be to increase the required provisions in line with asset prices in anticipation of a possible correction.
- **Volatility adjustment:** the volatility adjustment has the same aim as the matching adjustment, but for less predictable portfolios where the insurer is less certain that they will hold the assets to maturity. It confers only a portion of non-default spread to the valuation of liabilities and is published by EIOPA based on a representative portfolio of assets in a given currency or country.
- **Extrapolation:** Technical provisions are discounted with risk-free interest rates. The rates are based on market observations. For long maturities where no reliable market data are available the risk-free interest rates need to be extrapolated. The purpose of extrapolation is to ensure that the valuation of technical provisions and the solvency positions of insurers are not heavily distorted by strong fluctuations in the short-term interest rate.
- **Two transitional measures:** these allow insurers, for a limited period of time, to:
 - calculate their technical provisions by using the Solvency I discount rates, or
 - calculate technical provisions according to Solvency I rules.

The transitional measures will only apply to technical provisions for insurance contracts concluded before the start of the Solvency II regime. The transitional measures are designed to phase out in a linear way over the transitional period. They are needed to smooth the transition to Solvency II for contracts concluded under the previous solvency regime, which might otherwise risk disturbing the insurance market.

- **Extension of the recovery period:** in the event of exceptional adverse situations, as determined by EIOPA, the supervisory authority may extend the maximum recovery period in order to re-establish compliance with the Solvency Capital Requirement. Exceptional adverse situations include falls in financial markets, persistently low interest rate environments and high impact catastrophic events. The maximum extension is limited to 7 years. The extension of the recovery period is an element of the so-called 'ladder of intervention' which provides for intensified intervention by supervisors between the two levels of capital requirements – the solvency capital

requirements and (SCR) and the Minimum Capital Requirement (MCR) – in order to ensure that corrective measures are taken sufficiently early.

Own funds

The Directive distinguishes between basic own funds (the excess of assets over liabilities and subordinated liabilities) and ancillary own funds (contingent assets that are off-balance sheet). Own funds are further classified into three tiers depending on whether they substantially absorb losses on a going concern basis (permanent availability) and in a winding up (subordination), with tier 1 representing high quality own funds. Quantitative limits are used to determine what amounts of tiers 1, 2 and 3 own funds are eligible to cover the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

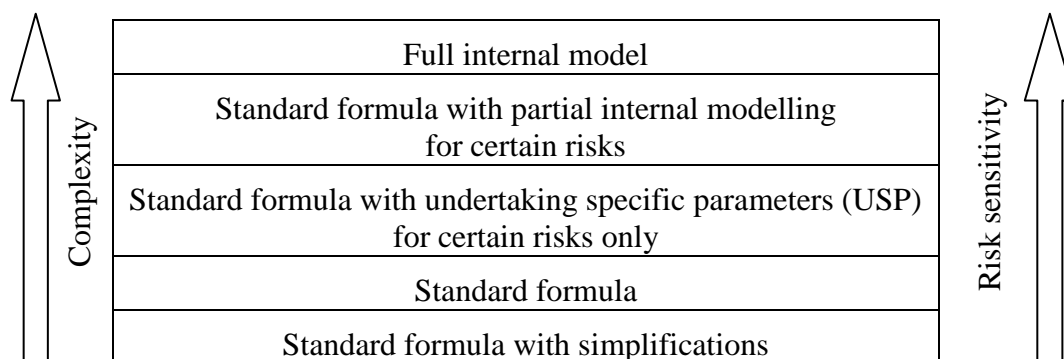
Capital Requirements

The Directive sets out a clear principle for the solvency capital requirements (SCR): they shall correspond to the own funds an insurer needs to have in order to survive the worst of 200 possible business years (in technical terms, the Value-at-Risk of the undertaking's basic own funds subject to a confidence level of 99.5 % and a time horizon of one year). The SCR should cover all quantifiable risk to which the undertaking is exposed, at least underwriting risk, market risk, credit risk and operational risk.

The assessment of the riskiness of insurance business is a complex task, because if certain financial benefits are guaranteed to the policyholder, the expectations on future liabilities of the firm are closely interlinked with the asset portfolio. In the impact assessment for the Directive, different methodologies for the measurement of insurance risk were assessed, and the so called scenario approach was chosen, which – whilst being not the most simple method – is capable of taking into account the interlinkedness of risk inherent in assets and liabilities. In the design of the Directive, it was also decided to implement the scenario based approach in different layers of complexity that would allow for an appropriate fit for different types of undertakings. Besides a standardised approach that could be used by insurers that run regular business, it was decided to offer firms the possibility to apply for more complex – so called "internal" - models that would be better targeted to their business and aligned with their risk management (a similar approach exists in the banking regulation). Firms that would not find the standard formula an appropriate fit for their business in only some areas will be allowed to use partial internal modelling for those areas.

In addition to internal models, that are rather elaborate and expensive to set up, proportionality consideration led to the decision to also allow more simple modifications to the standard formula. On the one hand, simplifications to the standard formula were introduced. On the other hand, undertakings are allowed to further refine the standard formula by replacing single parameters by parameters calculated in a way that provide a better fit to their business. In contrast to internal models, that allow for freedom of method, the undertaking specific parameters (USP) shall be calculated with standardised methods, in order to limit the cost for application process. These modifications will especially benefit SMEs, because they allow them to adapt the standard approach to the specificities of their business in a proportionate manner.

Figure 1: Possible levels of complexity and risk sensitivity in capital requirement calculation.



In relation to the standard formula for the SCR, the Directive sets out a modular structure with five modules (non-life underwriting risk, life underwriting risk, health underwriting risk, market risk and counterparty default risk), several sub-modules and two top-level adjustments (operational risk and loss-absorbing capacity of technical provisions and deferred taxes).

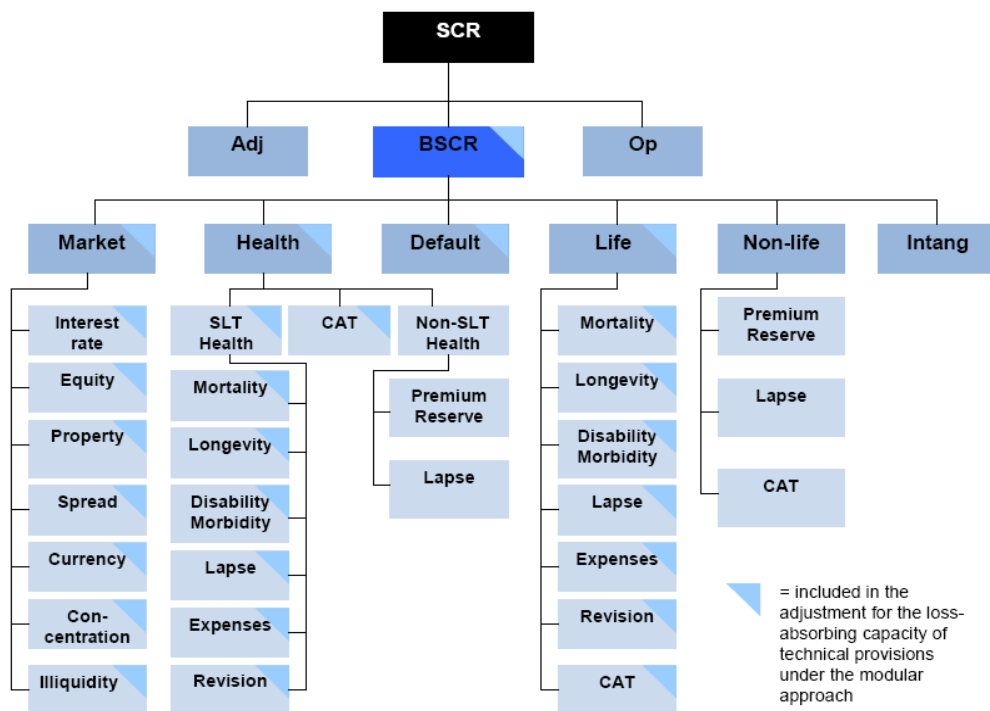
The Directive foresees specific approaches towards equity risk: counter-cyclical mechanism through a symmetric adjustment to the stress ("dampener") and a specific calibration for equities held to cover pension business under certain conditions, such as ring-fencing ("duration-based approach").

The Directive allows (re)insurers to take account of risk-mitigation techniques in the SCR, provided that any additional risks are captured.

In relation to internal models, the Directive foresees that these shall not be determined by pre-defined methods, but be designed by the firm in a manner that fits best their risk management. The Directive sets out general requirements on statistical quality, calibration, validation and documentation the design of internal models needs to fulfil. Internal models are subject to supervisory approval process, as well as on-going monitoring of their continuing appropriateness.

In relation to the ultimate level of supervisory intervention, the minimum capital requirement (MCR), the Directive sets out a simple factor-based approach based on volume measures (technical provisions, written premiums, administrative expenses etc.) to be calibrated at a 85% value-at risk level.

Figure 2 : structure of the standard formula



Groups

When setting out requirements for groups the Directive makes reference to the provisions established for individual undertakings by way of direct indication or by requiring mutatis mutandis application of these provisions at the level of groups. Requirements applicable to groups span all three pillars (quantitative requirements, governance, and disclosure and reporting).

By default, group supervision should apply at the level of the ultimate parent undertaking within the EU, with Member States having the option to exercise supervision on national or regional subgroups.

The group SCR can be calculated according to two methods: on the basis of consolidated data (default method) or using a deduction & aggregation method. The Directive provides that the group supervisor may allow the use of the latter method or a mixed method when the exclusive application of the former method would be inappropriate. Under the consolidation, all related undertakings are included in a group-wide Solvency II calculation and diversification benefits are recognised, meaning that groups are recognised as economic entities. Under the deduction & aggregation method, the solo capital requirements of related undertakings are aggregated, using third-country solvency rules when they are deemed equivalent, but without recognising diversification benefits.

The Directive requires that own funds should be appropriately distributed within the group and available to protect policy holders and beneficiaries. Therefore, an assessment of the availability of own funds of related undertakings in the group to cover the group SCR is necessary when calculating the group solvency.

The Directive also sets out provisions for the cooperation and exchange of information between supervisory authorities, within a college of supervisors for each group, led by the group supervisor designated by the Directive according to the structure of the group.

Equivalence

The Directive gives the Commission the authority to decide about the equivalence of third countries' solvency and prudential regimes, in three different contexts:

- when the solvency regime applicable to reinsurance activities carried out in a third-country is deemed equivalent, reinsurance contracts concluded between EU undertakings and reinsurers in this third country are treated as reinsurance contracts concluded within the EU and Member States are prohibited from requiring those reinsurers to post collateral;
- when the solvency regime applicable to third country insurers and reinsurers is deemed equivalent, the contribution of related third-country undertakings to the SCR and own funds of an EU group can be calculated in accordance with the rules of that third country, when the deduction & aggregation method is used (see above).
- when a third country's prudential regime for the supervision of groups is deemed equivalent, and a group headquartered in this third country has related undertakings in the EU, the Directive provides that Member States shall rely on the equivalent group supervision exercised by the third-country supervisory authorities. For example, in such a case, EU supervisory authorities cannot require the establishment of a holding company to create a single EU sub-group and supervise it.

In all three cases of equivalence, the Directive empowers the Commission to take permanent or temporary equivalence decisions regarding third-countries.

ANNEX 2. LIST OF DELEGATED ACTS FOR THE COMMISSION

This annex sets out the detailed list of all empowerments in the Directive (as amended by Omnibus II) which form the legal basis for adopting the Delegated Acts¹⁵⁷. The proposed Delegated Acts are based on the 4000 pages of technical advice provided in 2009 and 2010 by EIOPA (formerly CEIOPS), which were thoroughly publicly consulted on. Every EIOPA document referred to in this annex, as well as the comments received during their public consultation and resolution proposed by EIOPA, can be found EIOPA's website:

<https://eiopa.europa.eu/publications/sii-final-l2-advice/index.html>

A2.1 Key aspects, content list and publication date of disclosure of aggregate statistical data by supervisory authorities (Article 31(4))

The Directive requires supervisory authorities to conduct their tasks in a transparent and accountable manner, and thus requires that Member States ensure the disclosure of certain information.

The Delegated Acts require supervisory authorities to disclose on their website certain statistics on their local market (e.g. number of undertakings supervised) and to report on their action (e.g. number of inspections, number of internal models approved). The provisions in the Delegated Acts are based on EIOPA's advice.¹⁵⁸

A2.2 Information and deadlines for submission of information to be provided by insurance and reinsurance undertakings (Article 35 (9))

The impact assessment of the options relevant for these Delegated Acts is presented in section 5.6.

A2.3 Further specifications on the circumstances under which a capital add-on for supervisory purposes may be imposed and further specifications of methodologies calculating capital add-ons (Articles 37 (6) and (7))

The Directive allows supervisory authorities to set a capital add-on to the capital requirements in certain, specified circumstances:

- where the risk profile of the undertaking deviates significantly from the assumptions underlying the calculation of the Solvency Capital Requirement and a modification of the calculation method has been ineffective; or,
- where the system of governance deviates significantly from the standards laid down in the Directive and the application of other measures are unlikely to improve the deficiencies sufficiently.

¹⁵⁷The Solvency II Directive, as amended by Omnibus II (Article 301b) provides for a 'sunrise clause' whereby, in the interest of an early finalisation of the measures, during the first two years following entry into force of Omnibus II, the Commission shall adopt Regulatory Technical Standards in the form of ordinary Delegated Acts. Therefore, the list of empowerment set out in this annex covers empowerments for ordinary Delegated Acts as well as for Regulatory Technical Standards.

¹⁵⁸ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Transparency and Accountability', October 2009.

The Delegated Acts specify a methodology to calculate the capital add-on and a supervisory ladder of intervention. The provisions taken up in the Delegated Acts are based on EIOPA's advice.¹⁵⁹

A2.4 Further specifications on the elements of the system of governance, the risk management system, internal control system, internal audit and actuarial functions (Article 50 (1))

The architecture of the system of governance is defined in the Directive. The Delegated Acts flesh out the operational details of the general principles set out in the Directive, regarding the content of the written policies and the accounting procedures provided for by the Directive, and the detailed tasks of the actuarial function in calculating the technical provisions.

The issue of remuneration, which is part of the system of governance, is covered in this impact assessment report (see policy options in section 5.4). The provisions in the Delegated Acts are based on EIOPA's advice.¹⁶⁰

A2.5 Fit and proper conditions for persons who run the undertaking or have other key functions and conditions for outsourcing (Article 50 (2))

The Directive requires that persons who effectively run an insurance undertaking or have other key functions have professional qualifications, knowledge and experience, are adequate to enable sound and prudent management (fit), and are of good repute and integrity (proper).

The Delegated Acts specify the content of written policies regarding the assessment of these fit and proper conditions, and the content of written agreements regarding outsourcing, to ensure servicing continuity. These requirements are aligned with market best practice risk management policies, thus ensuring convergent supervisory standards. The provisions in the Delegated Acts are based on EIOPA's advice.¹⁶¹

A2.6 Specification of the elements of the overall solvency needs in the own risk and solvency assessment (Article 50 (3))

The Directive requires insurance undertakings to carry out an own risk and solvency assessment which includes a forward looking assessment of their overall solvency needs.

The Delegated Acts specify the details of the own risk assessment process. The provisions in the Delegated Acts are based on EIOPA's advice.¹⁶²

A2.7 Further specifications on the information which must be disclosed and the deadlines for annual disclosure (Article 56)

The impact assessment of the relevant options relevant is presented in section 5.6.

A2.8 Methods and assumptions to be used in the valuation of assets and liabilities, and the specification of the consistency of accounting standards with the valuation approach for assets and liabilities (Articles 75 (2) and (3))

The impact assessment of the relevant options is presented in section 5.5.

¹⁵⁹ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Capital add-on', October 2009

¹⁶⁰ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: System of Governance', October 2009

¹⁶¹ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: System of Governance', October 2009

¹⁶² 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: System of Governance', October 2009

A2.9 Actuarial and statistical methodologies to calculate the best estimate for technical provisions (Article 86 (1)(a))

The Directive sets out a principles-based standard methodology for the calculation of technical provisions in a high-level manner.

The Delegated Acts further specify this methodology by setting calculation assumptions (e.g. on the allowance for future management actions in the cash flow projections, or on the simulation of policyholder behaviour). These assumptions are aligned with standard actuarial practices and the provisions in the Delegated Acts are based on EIOPA's advice.¹⁶³

A2.10 Methodologies, principles and techniques for the determination of the relevant risk-free interest rate structure to be used to calculate the best estimate (Article 86 (1)(b))

The Directive sets out the calculation of the risk-free rate that is used to discount the technical provisions in some detail, including the need for extrapolation at maturities where market data is not available, the use of transitional measures and the use of the long-term guarantees measures to manage market volatility.

The Delegated Acts flesh out finer technical details of these calculations to ensure consistency and convergence (e.g. on the composition of representative portfolios, or the method to determine the risk-free rate for currencies pegged to the euro). The provisions in the Delegated Acts are based on EIOPA's advice and EIOPA's technical specification used for the long-term guarantees impact assessment which informed the Omnibus II negotiations¹⁶⁴.

A2.11 Circumstances in which technical provisions shall be calculated as a whole, or as a sum of a best estimate and a risk margin, and the methods to be used in the case where technical provisions are calculated as a whole (Article 86 (1)(c))

The Directive specifies that valuation as a whole (without including a risk margin) is only permitted where the obligations can be replicated reliably using financial instruments for which a reliable market value is observable.

The Delegated Acts outline when cash-flows cannot be regarded as reliably replicated, based on EIOPA's advice.¹⁶⁵

A2.12 Methods and assumptions to be used in the calculation of the risk margin including the determination of the amount of eligible own funds necessary to support the insurance and reinsurance obligations and the calibration of the cost-of-capital rate (Article 86 (1)(d))

The Directive requires that technical provisions shall include a risk margin, in order to ensure that the value of technical provisions is market consistent, i.e. corresponds to the transfer value of obligations.

The Directive requires that this risk margin is calculated on a cost-of-capital basis; the Delegated Acts set out the mechanics of this calculation (the risk margin is the discounted

¹⁶³ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Actuarial and statistical methodologies to calculate the best estimate', October 2009

¹⁶⁴ <https://eiopa.europa.eu/en/consultations/qis/insurance/long-term-guarantees-assessment/index.html>

¹⁶⁵ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calculation of Technical Provisions as a whole', October 2009

sum of the future solvency capital requirements of the party taking over the obligations) as well as the cost of capital rate. The provisions in the Delegated Acts are based on EIOPA's advice.¹⁶⁶

A2.13 Lines of business on the basis of which insurance and reinsurance obligations are to be segmented in order to calculate technical provisions (Article 86 (1)(e))

The Directive requires that technical provisions are segmented into lines of business.

These lines of business are defined in the Delegated Acts, in a manner that is closely aligned with the classes of insurance set out in the Directive, based on EIOPA's advice.¹⁶⁷

A2.14 Standards to be met with respect to ensuring the appropriateness, completeness and accuracy of the data used in the calculation of technical provisions, and the specific circumstances in which it would be appropriate to use approximations (Article 86 (1)(f))

The Directive requires that data used in the calculation of technical provisions is appropriate, consistent and complete.

The Delegated Acts further flesh out these criteria, in line with standard actuarial practice and based on EIOPA's advice.¹⁶⁸

A2.15 Specifications with respect to the requirements set out in the Directive for the use of the and the calculation of the matching adjustment (Articles 86 (1)(g) and (h))

The matching adjustment to the risk-free interest rate is a measure reducing artificial volatility in the valuation of certain long-term obligations that was introduced with the Omnibus II Directive. The Directive sets out the criteria for application of the matching adjustment and its calculation in considerable detail.

The Delegated Acts only clarify technical points and details, e.g. of how the maximum permitted threshold for mortality risk should be calculated; this calculation is aligned with the standard method for mortality risk in the Solvency Capital Requirement and corresponds with EIOPA's best practice as set out in the technical specifications for the long-term guarantees impact assessment.

A2.16 Methods and assumptions for the calculation of the volatility adjustment and the methodologies to be used when calculating the counterparty default adjustment designed to capture expected losses due to default of the counterparty (Articles 86 (1)(i) and (2)(a))

The Directive sets out the calculation of the volatility adjustment in detail.

The Delegated Acts clarify a few technical points to ensure the transparency of the calculations to be performed by EIOPA (who is responsible for publishing the volatility adjustments), e.g. further details on the composition of the reference portfolio and how to consistently adjust for expected counterparty default risks in the technical provisions. These

¹⁶⁶ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calculation of Technical Provisions as a whole', October 2009

¹⁶⁷ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Lines of business on the basis of which (re)insurance obligations are to be segmented', October 2009

¹⁶⁸ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calculation of Technical Provisions as a whole', October 2009

clarifications are aligned with EIOPA's best practice as set out in the technical specifications for the long-term guarantees impact assessment, which informed the Omnibus II negotiations¹⁶⁹.

A2.17 Simplified methods and techniques to calculate technical provisions (Article 86 (2)(b))

The Directive requires that the Delegated Acts set out criteria for the use of simplified methods to calculate technical provisions, where necessary to ensure that the actuarial and statistical standard methods are proportionate (see A2.9).

The Delegated Acts set out conditions under which simplifications can be used (e.g. appropriateness and prudence conditions on errors introduced), based on EIOPA advice.¹⁷⁰

A2.18 Criteria for granting supervisory approval of ancillary own funds (Article 92(1))

The Directive states that own funds shall be comprised of basic own funds and ancillary own funds.

The Delegated Acts set out the technical criteria for approving ancillary own funds, which consist of off balance sheet items. The provisions in the Delegated Acts are based on EIOPA's advice.¹⁷¹

A2.19 Treatment of participations in financial and credit institutions with respect to the determination of own funds (Article 92(1a))

The Directive requires Delegated Acts to be drafted on the treatment of participations in financial and credit institutions.

The Delegated Acts set out how these investments should be deducted from insurers' own funds to avoid double gearing across sectors. The provisions in the Delegated Acts are based on EIOPA's advice.¹⁷²

A2.20 List of own funds items that fulfil the criteria set out in the directive, and the methods to be used by supervisory authorities when approving own fund items which are not covered by the list (Article 97)

The Directive requires the classification of own funds into three tier according to their permanence and loss absorbency.

The Delegated Acts set out the list of permissible own fund items that fulfil the criteria for the various tiers, based on EIOPA's advice.¹⁷³

A2.21 Quantitative limits for own funds items, possibly stricter than those set in the Directive. (Article 99(a))

¹⁶⁹ <https://eiopa.europa.eu/en/consultations/qis/insurance/long-term-guarantees-assessment/index.html>

¹⁷⁰ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Simplified methods and Techniques to calculate Technical Provisions', October 2009

¹⁷¹ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Own Funds – Classification and Eligibility', October 2009

¹⁷² 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Treatment of Participations', October 2009

¹⁷³ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Own Funds – Classification and Eligibility', October 2009

This area is covered in the impact assessment in section 5.3. The option taken up in the draft Delegated Acts is in line with EIOPA's advice on the limits.

A2.22 Adjustments to own funds that shall be made to reflect the lack of transferability of those own-fund items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (Article 99(b))

The Directive requires the use of adjustments to own funds where the own funds cannot be used to support losses in the remainder of the undertaking, but are set aside to cover specific risks only. In such cases those own funds should not be included for the purposes of demonstrating overall solvency.

The Delegated Acts set out the technical details of the necessary deductions to own funds, based on EIOPA's advice.¹⁷⁴

A2.23 The methodology and requirements for the calculation of health risk equalisation systems (HRES) standard deviations and additional criteria that national legislative measures on HRES shall meet (Article 109a(4))

The Directive sets out that the capital requirement for premium and reserve risk may be reduced where a national system for claims sharing is established within a Member State.

The Delegated Acts set out a standard methodology for the calculation of the adjustment factor that is aligned with the methodology to calculate undertaking specific parameters. They also complete the list of criteria set out in the Directive that HRES must meet to be eligible for this method. The provisions in the Delegated Acts are based on EIOPA's technical specifications for the most recent quantitative impact studies¹⁷⁵.

A2.24 Standard formula in accordance with the Directive (Article 111(1)(a))

The structure of the standard formula for the calculation of capital requirements is determined in the Directive (see Annex 1).

The Delegated Acts provide for the operational details necessary for performing the calculation. This general empowerment allows setting out the standard formula in the Delegated Acts in more detail as provided for in the Directive. No relevant policy decisions are related to it, as the elements of the standard formula are covered in the more detailed empowerments below.

A2.25 Sub-modules necessary or covering more precisely the risks which fall under the risk-modules of the standard formula set out in the Directive (Article 111(1)(b))

The Directive sets out the majority of the sub-modules of the standard formula.

The Delegated Acts add an additional sub-module for non-life lapse risk, a more granular approach for non-life catastrophe risk, a more granular approach to health underwriting risk, and additional sub-module for intangible assets. These refinements are based on EIOPA advice¹⁷⁶ and are in line with standard actuarial practice.

¹⁷⁴ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Treatment of ring-fenced funds', October 2009

¹⁷⁵ See the technical specification for QIS5:

<https://eiopa.europa.eu/en/consultations/qis/insurance/quantitative-impact-study-5/index.html>

¹⁷⁶ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Health Underwriting Risk', October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II:

Options related to additional refinements of the market risk modules, in relation to long-term investment objectives, are discussed in section 5.1.

A2.26 Methods, assumptions and parameters of the standard formula (Article 111(1)(c))

The Directive sets out the metrics for the calibration of the standard formula (99,5% value at risk over a one year horizon).

The Delegated Acts specify assumptions and parameters for the standard formula -based on EIOPA advice-¹⁷⁷ to comply with the metric set out in the Directive. The methods and calibration of some specific parameters applicable to long-term investments (where the Delegated Acts deviate from EIOPA advice) and the equity risk dampener, are impact assessed in sections 5.1 and 5.2 respectively.

A2.27 Correlation parameters of the standard formula (Article 111(1)(d))

The Directive sets out the correlation parameters between the major modules of the standard formula that serve the purpose of combining the risk charges of the standard formula. As their calibration involves assumption of the probability of the simultaneous events simulated in different risk modules, they reduce the overall risk charge.

The Delegated Acts- specify the correlation parameters for the sub-modules within the major modules, based on EIOPA advice¹⁷⁸.

A2.28 Methods and assumptions on risk-mitigation techniques in the standard formula and qualitative criteria that risk-mitigation techniques need to fulfil (Articles 111(1)(e) and (f))

The Directive sets out that the calculation of the Solvency Capital Requirement shall take account of risk-mitigation techniques.

The Delegated Acts specify qualitative criteria on the admissibility of reinsurance contracts, finite reinsurance, special purpose vehicles, financial risk-mitigation, collaterals and guarantees within the standard formula, and specify how risk-mitigation effects can allocated

SCR Standard Formula - Life Underwriting Risk', October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Non-Life Underwriting Risk', October 2009

¹⁷⁷ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Health Underwriting Risk': October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Calibration of Health Underwriting Risk': April 2010; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Life Underwriting Risk': October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Calibration of Life Underwriting Risk': April 2010; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Non-Life Underwriting Risk': October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Calibration of Non-Life Underwriting Risk': April 2010 (amended 2011 by EIOPA's recalibration exercise of Premium and Reserve Risk and by EIOPA's report on Non-Life Catastrophe Risk); 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Counterparty Default Risk': October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Market Risk Module': October 2009; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Calibration of the Market Risk Module': January 2010; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Equity Risk Sub-Module': January 2010

¹⁷⁸ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula Correlations': January 2010

across sub-modules in a manner that is consistent with the design of the standard formula. These provisions are aligned with other Union legislation (in particular CRDIV).

A2.29 Methods and parameters for counterparty default risk of central counterparties (Article 111(1)(fa))

The Directive seeks for consistency in the methods and parameters to be used in the treatment for credit, insurance and financial institutions for exposures to qualifying central counterparties.

The Delegated Acts specify a loss-given-default approach for calculation counterparty default risk on central counterparties, in line with actuarial best practice and based on EIOPA's advice¹⁷⁹.

A2.30 Methods and parameters for operational risk (Article 111(1)(g))

The Directive requires that the Solvency Capital Requirement covers operational risk.

The Delegated Acts provide for the calibration of the risk charge for operational risk based on EIOPA's advice.¹⁸⁰

A2.31 Methods and adjustments to reflect the reduced scope of risk diversification relating to ring-fenced funds (Article 111(1)(h))

According to the Directive ring-fenced funds are portfolios of assets and insurance obligations that are managed and organised separately from the remaining business, without any possibility of transfer. Because of the limited transferability of assets, also the diversification between ring-fenced funds and the remaining business is limited.

The Delegated Acts set out how this limited scope of diversification is accounted for in the calculation of the capital requirements.

A2.32 Method to be used when calculating the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes (Article 111(1)(i))

The Directive sets out that the capital requirements calculated with the standard formula can be reduced by adjustments for the loss-absorbing capacity of technical provisions and deferred taxes.

The Delegated Acts, based on EIOPA advice, set out the technical details of this calculation.¹⁸¹

A2.33 The subset of standardised parameters in life, non-life and health underwriting risk that may be replaced by undertaking-specific parameters (USP), the standardised methods to be used to calculate the USP and criteria with respect to the completeness, accuracy and appropriateness of the data used to calculate USP (Articles 111(1)(j) and (k))

¹⁷⁹ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR standard formula - Counterparty default risk module' October 2009.

¹⁸⁰ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula – Operational Risk': October 2009.

¹⁸¹ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Loss-absorbing Capacity of Technical Provisions and Deferred Taxes': October 2009

The Directives provides that some parameters of the standard formula may be replaced by parameters that the undertaking calculates based on its own data by using standardised methods.

The Delegated Acts, based on EIOPA advice, specify the parameters that can be replaced by USP, set out the standardised methods as well as the criteria for the quality of data that is used for the purpose of their calculation¹⁸².

A2.34 The approach on equity risk for related undertakings (Article 111(1)(m))

The Directive requires that the Delegated Acts set out provisions on the specific treatment of equity risk within the standard formula, taking into account the likely reduction of volatility of the value of related undertakings arising from the strategic nature of investments.

The Delegated Acts set out a specific calibration for strategic participations as well as strict criteria that must be fulfilled for participations that benefit from this charge. These provisions are based on EIOPA advice¹⁸³.

A2.35 Use of external credit assessments (Article 111(1)(n))

For the purpose of the calculation of capital requirements in accordance with the standard formula, the Delegated Acts set out credit quality steps and general requirements. These are aligned on the banking regulation (CRR article 135 and following).

A2.36 Criteria for the equity index for the symmetric adjustment mechanism for equity risk (Article 111(1)(o))

The Delegated Acts determine the composition and transparency requirements for the index used for the calculation of the equity dampener (for more details see section 5.2). These provisions are aligned with EIOPA's best practice in calculating the symmetric adjustment for the purpose of all quantitative impact studies¹⁸⁴.

A2.37 Criteria for the adjustments to the capital requirement for currency risk for currencies pegged to the Euro (Article 111(1)(p))

The Directive requires that the Delegated Acts set out a method and criteria for facilitating the calculation of currency risk in the standard formula for currencies pegged to the Euro.

The Delegated Acts set out standard straightforward criteria to consider a currency as pegged e.g. the participation of the currency in the European Exchange Rate Mechanism and the recognition of the pegging arrangement by a Council Decision.

A2.38 Conditions for a categorisation of regional governments and local authorities (Article 111(1)(q))

The Directive requires that the Delegated Acts set out criteria under which exposures to regional governments and local authorities can be treated as exposures to the central government. These provisions are aligned with the banking regulation (Article 115 of CRR).

¹⁸² 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula - Undertaking-specific Parameters': October 2009

¹⁸³ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Treatment of participations' January 2010

¹⁸⁴ See the technical specification for QIS5:

<https://eiopa.europa.eu/en/consultations/qis/insurance/quantitative-impact-study-5/index.html>

A2.39 Calculation of the minimum capital requirement (Article 130)

The Directive defines the minimum capital requirement as second line of supervisory intervention (at a Value-at-risk level on 85%), and requires that it be calculated with a factor based approach.

The Delegated Acts set out the calibration of this approach, based on EIOPA advice.¹⁸⁵

A2.40 The adaptations to be made to the tests and standards for internal models in light of the limited scope of the application of the partial internal model (Article 114(1a))

The Directive permits the use of partial internal models, whereby undertakings can combine parts of the standard formula with an internal model subject to compliance with the relevant tests and standards.

Throughout the Delegated Acts relating to the internal model tests and standards, the necessary adaptations are specified for the use of partial internal models, based on EIOPA advice¹⁸⁶. These apply the same standards to the amended scope of the partial model, as would apply to full internal models.

A2.41 The way in which a partial internal model shall be fully integrated into the Solvency Capital Requirement standard formula and requirements for the use of alternative integration techniques (Article 114(1b))

According to the Directive undertakings may select the most appropriate of these techniques or propose a different technique if none of the ones provided are appropriate. The integration technique is required to meet the tests and standards applicable to partial internal models.

The Delegated Acts specify several integration techniques and the corresponding formulas, based on EIOPA advice¹⁸⁷.

A2.42 To enhance the better assessment of the risk profile and management of the business of insurance and reinsurance undertakings with respect to the tests and standards for internal models (Article 126)

The Delegated Acts relating to the internal model tests and standards, based on EIOPA advice, emphasise better risk assessment and management throughout, since this is one of the broader aims of permitting undertakings to use internal models for the calculation of their capital requirements¹⁸⁸.

A2.43 To further specify the tests and standards for internal models (Article 127)

The Directive imposes that undertakings using internal models comply with certain tests and standards (e.g. on statistics, calibration and validation).

¹⁸⁵ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calibration of the MCR': April 2010; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calculation of the MCR': October 2009.

¹⁸⁶ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Partial internal models: January 2010'

¹⁸⁷ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Partial internal models: January 2010'

¹⁸⁸ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Test and Standard for Internal Model Approval: July 2009'

The Delegated Acts set out in more details the tests and standards prescribed by the Directive to ensure they are applied consistently in the EU. These provisions are based on EIOPA's advice¹⁸⁹.

A2.44 Specification of the calculation of the minimum capital requirements (Article 130)

The Directive requires the calculation of a minimum capital requirement in addition to the solvency capital requirement. A breach of the minimum capital requirement triggers greater supervisory action than a breach of the solvency capital requirement, in keeping with the 'ladder of supervisory intervention'.

The Delegated Acts, based on EIPA advice, set out a factor-based approach and a calibration to comply with the calibration objective set out in the Directive (at the level of an 85% value-at-risk)¹⁹⁰.

A2.45 Requirements to be met by undertakings that repackage loans into tradable securities and other financial instruments in order for an insurance undertakings to be allowed to invest in such securities or instruments (Article 135(2)(a))

The Directive provides that undertakings may only invest in securitisation if the transaction involves risk retention by the originator, which must keep a minimum economic interest in the transaction.

The Delegated Acts implement this risk retention requirement, further specifying the minimum economic interest. These provisions are aligned on the banking regulation (CRR article 405).

A2.46 Qualitative requirements that must be met by insurance or reinsurance undertakings that invest into securities or other financial instruments based on repacked loans (Article 135(2)(b))

The Directive also provides that undertakings may only invest in securitisation if they satisfy certain qualitative requirements.

The Delegated Acts implement due diligence and risk management requirements for insurance undertakings investing into securitisation. These provisions are aligned with banking regulation (article 406 of CRR).

A2.47 Specification for circumstances under which an additional capital charge may be imposed on investments in securities or other financial instruments based on repacked loans (Article 135(2)(c))

The Directive provides that risk factors applied to investments in securitisation must be increased if the undertaking does not comply with the above requirements (risk retention and qualitative requirements).

The Delegated Acts specify the circumstances under which such increased risk factors may be imposed. These provisions are aligned with the banking regulation (CRR article 407).

¹⁸⁹ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Articles 120 to 126 - Tests and Standards for Internal Model Approval' October 2009

¹⁹⁰ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calibration of the MCR': April 2010; 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Calculation of the MCR': October 2009.

A2.48 Methodology for the calculation of the additional capital charge on securities or other financial instruments based on repacked loans (Article 135(2)(a))

The Directive provides that risk factors applied to investments in securitisation must be increased if the undertaking does not comply with the above requirements (risk retention and qualitative requirements).

The Delegated Acts specify a formula to set the increased risk factors. These provisions are aligned with the banking regulation (CRR article 407).

A2.49 To supplement the exceptional adverse situations and the factors and criteria taken into account by EIOPA when declaring the existence of exceptional adverse situations under which the recovery period may be extended, and by supervisory authorities in determining the extension of the recovery period (Article 143(1))

The Directive permits an extension of the recovery period following a breach of the capital requirements where exceptional adverse situations prevail, as determined by EIOPA.

The Delegated Acts set out some brief criteria to be considered by EIOPA to declare the existence of exceptional adverse situations as defined in Article 138 of the directive and undertaking-specific factors for supervisors to decide on the length of the extension. The factors and criteria focus on the transparency and clarity of the process, given that the political issues around the recovery period (e.g. maximum length of the extension) were settled in the Directive by Omnibus II.

A2.50 Specify the recovery plan and the finance scheme (Article 143(2))

The Directive outlines the content of these two documents, which must be submitted to supervisors in case of breach of the capital requirements. The Delegated Acts must flesh out the specific elements to include.

A2.51 Criteria to assess whether a solvency regime applicable to reinsurance activities of undertakings located in a third-country is equivalent (Article 172(1))

For the purpose of calculating the solvency capital requirement of an EU undertaking, the Directive allows reinsurance contracts concluded with reinsurers located in third-countries to be treated as if they were concluded with EU reinsurers, where the third-country solvency regime applicable to reinsurers is deemed equivalent to Solvency II.

The Delegated Acts specify criteria for the Commission to assess whether a third-country solvency regime is equivalent, including criteria about the quantitative and qualitative requirements in the third-country and powers of the third-country authorities. These criteria are based on EIOPA advice¹⁹¹.

A2.52 Specification criteria for supervisory approval on the scope of the authorisation of special purpose vehicles, conditions to be included in all the contracts issued, fit and proper requirements, system of governance, information and solvency requirements (Article 211(2))

¹⁹¹ CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical criteria for assessing 3rd country equivalence in relation to art. 172, 227 and 260. The issue of *temporary* equivalence, with lighter criteria to grant an equivalent status to third countries, was later debated and settled in the negotiation of the Omnibus II Directive in 2013

The Directive permits the use of 'special purpose vehicles', which are vehicles conducting operations similar to reinsurance.

The Delegated Acts specify criteria for special purpose vehicles in order to ensure that there is an effective transfer of risk. These provisions are based on EIOPA advice¹⁹².

A2.53 Circumstances under which national supervisory authorities can decide to exercise supervision on national or regional sub-groups (Articles 216(7))

The Directive requires in any case that group supervision be exercised at the level of the ultimate parent undertaking in the Union, and leaves an option for Member States to allow national supervisors to exercise group supervision on a national sub-group (at the level of the ultimate parent undertaking within a Member State).

The Delegated Acts set out limited circumstances where such a decision can be made (only in case of objective differences in the operations, the organisation or the risk profile between the sub-group and the group). This is in line with the objective to keep the number of levels of group supervision limited (see recital 99 of the Directive).

A2.54 Circumstances under which national supervisory authorities can decide to exercise supervision on regional sub-groups (Articles 217(3))

In addition to the option described above, the Directive leaves an option for Member States to allow their national supervisors to exercise group supervision on a regional sub-group (at the level of a parent undertaking covering several Member States).

The Delegated Acts frame this option in the same manner as the option to exercise supervision on a national sub-group, described above.

A2.55 Criteria to assess whether a third country solvency regime is equivalent, for the purpose of EU group supervision (Article 227(3))

For the purpose of EU group supervision including related third-country undertakings in its scope, when the deduction and aggregation method is used to calculate the group Solvency Capital Requirement and where the third-country solvency regime is found equivalent to Solvency II, the Directive allows the use of the third-country solvency rules in relation to the contribution of the related third-country undertaking to the group SCR.

The Delegated Acts specify criteria for the Commission to assess whether a third-country solvency regime is equivalent, including criteria about the quantitative and qualitative requirements in the third-country and powers of the third-country authorities. These criteria are based on EIOPA advice¹⁹³.

A2.56 Technical principles and methods regarding group solvency calculation, in accordance with the standard formula or internal models (Article 234)

The Directive provides two different methods for calculating group solvency: one based on group-wide consolidated data (using the standard formula or an internal model) and the other

¹⁹² CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles' October 2009

¹⁹³ 'CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical criteria for assessing 3rd country equivalence in relation to art. 172, 227 and 260'. The issue of *provisional* equivalence, with lighter criteria to grant an equivalent status to third countries, was later debated and settled in the negotiation of the Omnibus II Directive in 2013

based on the deduction and aggregation of each undertaking's contribution to the group own funds and capital requirement.

The Delegated Acts specify technical aspects regarding the group solvency calculation, such as the methods to include related undertakings (full consolidation, proportional consolidation or adjusted equity method), the scope of diversification effects within the group, or the availability of own funds items for the group, e.g. the treatment of minority interests. These provisions are based on EIOPA advice¹⁹⁴, consistent with accounting best practices (regarding consolidation rules), with rules in the banking sector and with the rules applicable to financial conglomerates (Directive 2002/87/EC, aka. FICOD).

A2.57 Criteria to assess whether a group has a centralized risk management (Article 241(a))

The Directive provides that when a group has a centralised risk management, some decisions (eg. the decision to impose a capital add-on when the risk profile of the group deviates from the standard formula or the internal model used to calculate the solvency capital requirement) should be taken by supervisors after a closer cooperation.

The Delegated Acts specify in more details one of the criteria in Article 236 of the Directive, relating to risk management and internal control processes in the group. These provisions are based on EIOPA advice¹⁹⁵.

A2.58 Criteria to define an emergency situation in a group with centralised risk management (Article 241(b))

Within a group with centralised risk management, when a subsidiary's financial condition is deteriorating, the Directive empowers the competent supervisor to take measures on its own if the college of supervisors fails to agree on the necessary measures within one month.

The Delegated Acts specify that such an emergency procedure should only be followed when longer consultation would jeopardise the effectiveness of the measures to be taken and cause further deterioration of the situation. These provisions are based on EIOPA advice¹⁹⁶.

A2.59 Procedures for the cooperation of supervisory authorities when a group has a centralised risk management (Article 241(c))

The Directive provides that the parent undertaking in a group can only be subject to the centralised risk management regime if it applies for it with competent supervisors.

The Delegated Acts specify the administrative details to handle an application from a parent company to subject one or several subsidiaries to the centralised risk management regime. These provisions are based on EIOPA advice¹⁹⁷.

A2.60 Definition of significant risk concentrations (Article 244(4))

The Directive provides that insurance groups must report significant risk concentrations, depending on appropriate identification thresholds to be set by the group supervisor, in cooperation with other authorities concerned.

¹⁹⁴ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Assessment of Group Solvency' October 2009

¹⁹⁵ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Group Solvency for Groups with Centralised Risk Management' October 2009.

¹⁹⁶ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Group Solvency for Groups with Centralised Risk Management' October 2009.

¹⁹⁷ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Group Solvency for Groups with Centralised Risk Management' October 2009.

The Delegated Acts specify that significant risk concentrations are those that could threaten the group solvency or liquidity position. These provisions are based on EIOPA advice¹⁹⁸ and are consistent with the work being carried out by the three European Supervisory Authorities (including EIOPA) regarding the supervision of risk concentrations in financial conglomerates (draft regulatory technical standard based on Article 21(1a) of the FICOD Directive).

A2.61 Identification and thresholds for the reporting of significant risk concentrations (Article 244(4a))

The Delegated Acts specify a minimum list of elements for supervisors to consider in order to identify significant risk concentrations and to set thresholds for reporting. These provisions are based on EIOPA advice¹⁹⁹.

A2.62 Definition of significant intragroup transactions (Article 245(4))

The Directive provides that insurance groups must report significant intragroup transactions.

The Delegated Acts specify that significant risk concentrations are those that materially influence the solvency or liquidity position of the group or of one of the undertakings involved in these transactions. These provisions are based on EIOPA advice²⁰⁰ and are consistent with the work being carried out by the three European Supervisory Authorities (including EIOPA) regarding the supervision of intragroup transactions in financial conglomerates (draft regulatory technical standards based on Article 21(1a) of the FICOD Directive).

A2.63 Identification of significant intragroup transactions (Article 245(4a))

The Delegated Acts specify a minimum list of elements for supervisors to consider in order to identify significant intragroup transactions. These provisions are based on EIOPA advice²⁰¹ and are consistent with the work being carried out by the three European Supervisory Authorities (including EIOPA) regarding the supervision of intragroup transactions in financial conglomerates (draft regulatory technical standard based on Article 21(1a) of the FICOD Directive).

A2.64 Coordination of group supervision in colleges of supervisors (Article 248(7))

The Directive provides that colleges of supervisors must be set up, defining the group supervisors and the other members of the college.

The Delegated Acts specify the content of the coordination arrangement to be adopted in each college of supervisors (pursuant to Article 248(4) of the Directive) and procedures for other

¹⁹⁸ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Risk Concentration and Intra-Group Transactions' October 2009

¹⁹⁹ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Risk Concentration and Intra-Group Transactions' October 2009

²⁰⁰ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Risk Concentration and Intra-Group Transactions' October 2009

²⁰¹ CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervision of Risk Concentration and Intra-Group Transactions' October 2009

authorities to request or be invited to participate in relevant college activities. These provisions are based on EIOPA advice²⁰².

A2.65 Definition of a significant branch (Article 248(8))

The Directive provides that in principle, members of the college of supervisors of a given group are the authorities from Member States where subsidiaries of the group are established. The Directive also provides that authorities from Member States where a significant branch of the group is located can participate in college activities.

In order to identify significant branches, the Delegated Acts specify a threshold for the size of the branch relative to the group, in term of gross written premiums. These provisions are based on EIOPA advice²⁰³.

A2.66 Specification of the information to be exchanged by supervisory authorities, to ensure consistent coordination (Article 249(3))

The Directive requires members of the college of supervisors to cooperate closely. For example, the Directive requires them communicate to one another without delay all relevant information as soon as it becomes available. A list of exceptional circumstances where a meeting of the college should be convened immediately is laid down in the Directive.

The Delegated Acts specify which (existing) elements of the regular supervisory reporting (including quarterly quantitative templates) and of the information disclosed to the public shall be exchanged on a systematic basis within the college. These provisions are based on EIOPA advice²⁰⁴.

A2.67 Further specification of the content and deadline to disclose the group solvency and financial condition report (Article 256(4))

The Directive lays down a detailed list of topics that the public report (SFCR) must cover for every undertaking. The Directive also requires groups to submit a group-specific public report, possibly replacing in one document all the SFCRs of each undertakings of the group (single group SFCR).

The Delegated Acts specify the content of the group SFCR, following the same structure as the SFCR for solo undertakings, only adding obvious group specific items (e.g. the description of the method of calculation of the group Solvency Capital Requirement, either consolidation or deduction and aggregation). These provisions are based on EIOPA advice²⁰⁵.

A2.68 Criteria to assess whether the prudential regime in a third country for the supervision of groups is equivalent (Article 260(2))

In the case of groups where the ultimate parent undertaking is located in a third-country, and where the group supervision of the third-country is deemed equivalent to Solvency II, the

²⁰² CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Cooperation and Colleges of supervisors' October 2009

²⁰³ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Cooperation and Colleges of supervisors' October 2009

²⁰⁴ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Cooperation and Colleges of supervisors' October 2009

²⁰⁵ 'CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervisory Reporting and Public Disclosure Requirements' October 2009

Directive requires EU authorities to rely on group supervision exercised by third-country authorities, e.g. their power to require the establishment of an EU holding company to be subject to group supervision in the EU is denied in case of equivalence.

The Delegated Acts specify criteria for the Commission to assess whether a third-country prudential regime for the supervision of groups, including criteria about the quantitative and qualitative requirements in the third-country and powers of the third-country authorities. These criteria are based on EIOPA advice²⁰⁶.

A2.69 Scope of the transitional measure gradually increasing the standard parameters in the equity risk sub-module in the first seven years of application (Article 308b(13))

Omnibus II introduced in the Solvency II Directive a transitional, phasing-in measure whereby the risk factors applicable to equities would gradually increase in the first seven years of application.

The Delegated Acts empowerment is to specify the type of equities eligible for this transitional measure. The Delegated Acts follow the straightforward split among equities, which is already implemented for the calculation of equity risk. Only "type 1" equities (mostly, equities listed on a regulated market in the OECD) are eligible to this transitional. "Type 2" equities are excluded because it is a catch-all category which captures the riskiest equities and other non-equity instruments.

A2.70 Changes in the group solvency where one undertaking in the group is using the transitional measure on equity risk set out in Article 308b(13) (Article 308b(17))

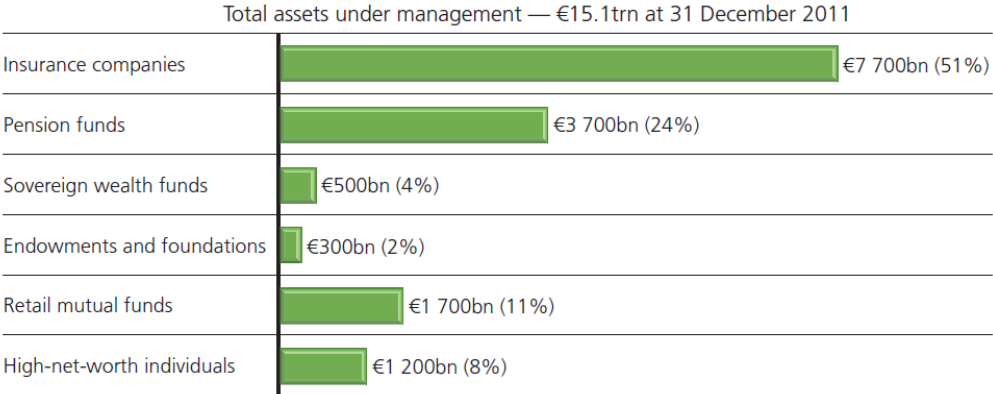
The Directive provides that the group Solvency Capital Requirement must be calculated in a manner consistent with the solo Solvency Capital Requirement.

In the Delegated Acts, the straightforward solution is that equity risk in the group is calculated on the basis of the risk factors applicable in each undertaking of the group (either the standard or the transitional risk factor).

²⁰⁶ See "CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Technical criteria for assessing 3rd country equivalence in relation to art. 172, 227 and 260" (CEIOPS-DOC-78/10). The issue of *temporary* equivalence, with lighter criteria to grant an equivalent status to third countries, was later debated and settled in the negotiation of the Omnibus II Directive in 2013.

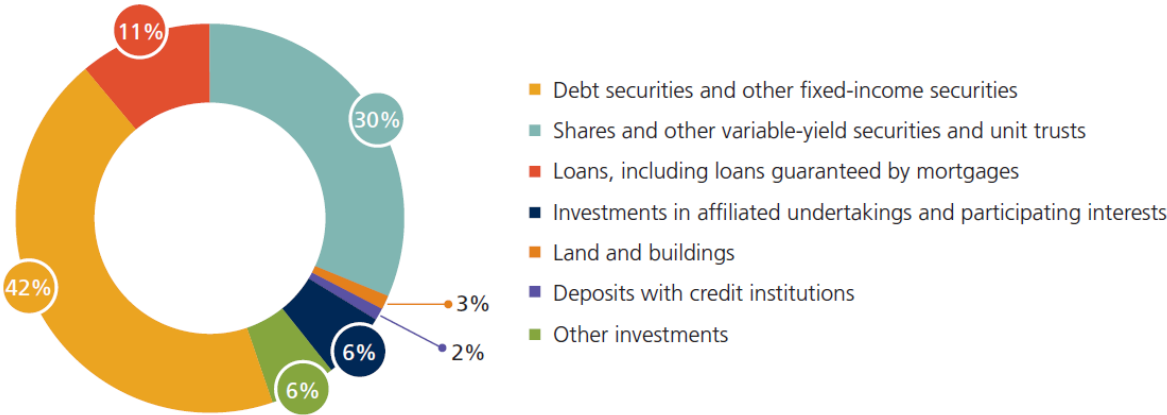
ANNEX 3. INSURERS INVESTMENT PORTFOLIO

Figure 1: European institutional investors' assets under management – 31 December 2011²⁰⁷



Developments in the total investment portfolio are mainly driven by life business, since the investment holdings of the life insurance industry account for more than 80% of the total. The UK, France and Germany jointly account for over 60% of all European life insurers' investments. In 2011 the largest components of European insurers' investment portfolio were debt securities and other fixed income assets (42%), followed by shares and other variable-yield securities (30%). Loans represented 11% of the total.

Figure 2: European insurers' investment portfolio 2011



²⁰⁷ “Funding the future: insurers’ role as institutional investors”, Insurance Europe & Oliver Wyman, June 2013

ANNEX 4. DEFINING "LONG-TERM INVESTMENT" AND "LONG-TERM FINANCING"

Long-term investment can be defined as investment into *productive activities* which support sustainable growth. Such activities drive economic growth and competitiveness by increasing private and public sector productivity, reducing costs, diversifying means of production and creating jobs:

- *Smart long-term investment* strengthens knowledge and innovation as drivers of our future growth;
- *Sustainable long-term investment* builds a resource efficient, sustainable and competitive economy, particularly for manufacturing, infrastructure and SMEs;
- *Inclusive long-term investment* creates new jobs in key sectors of the 21st century economy (e.g. the green economy, ICT, healthcare) which have the potential to underpin higher rates of employment and a cohesive society.

Infrastructure and SMEs are key contributors to sustainable growth and employment. High quality infrastructure is essential to ensure the efficient functioning of the economy. Well-developed infrastructure promotes the integration of the European market and facilitates the more effective use of other capital goods, thus supporting sustainable growth. Investment needs for transport, energy and telecom infrastructure networks of EU importance are estimated at EUR 1 trillion for the period up to 2020. Significant investment will also be needed in R&D, new technologies and innovation, as the main priorities set out in the Europe 2020 strategy.

SMEs are the backbone of our economy, representing over 99% of companies in the EU. They contribute significantly to GDP growth through their overall importance as well as their ability to innovate and grow. SMEs account for a large share of employment and value added, representing around two thirds of workforce and nearly 60% of value in the EU.

Long-term financing refers to the financing of long-term investment in a sustainable way. In addition to the focus on productive capital, as discussed above, long-term financing should also embody other key features:

- *Patient capital* is concerned with long-term investment performance and therefore the expectation to hold an asset for a long or indefinite period of time. This type of financing acts in a counter-cyclical manner and can promote financial stability by helping to correct short-term speculation and providing a buffer during a financial crisis;
- *Engaged capital* implies a sustained and direct engagement by asset owners, coupled with consideration of environmental, social, governance and other longer-term issues in their investment strategies. This kind of engagement can ensure better alignment of incentives with longer term interests throughout the investment chain.

ANNEX 5. CRITERIA TO DEFINE HIGH QUALITY SECURITISATION AND RECENT LEGISLATION TO RESTORE SAFE AND SUSTAINABLE SECURITISATION MARKETS IN THE EU

The importance of reviving safe and sustainable securitisation markets in the EU has already been well documented in the Commission Communication on the long-term financing of the European economy²⁰⁸ and in the joint paper released by the European Central Bank and the Bank of England in April 2014²⁰⁹.

The Delegated Acts for Solvency II are the first piece of legislation in the Union to implement a more favourable prudential treatment for high-quality securitisation, as announced in the above mentioned Communication.

This annex outlines the criteria to identify high-quality securitisation, as recommended by EIOPA in its December 2013 *Technical report on the design and calibration of the standard formula for certain long-term investments*²¹⁰ and included by the Commission in the Delegated Acts. These criteria are broadly based on those used by the European Central Bank to determine which asset-backed securities are eligible as collateral for refinancing. These criteria are carefully designed to fix earlier flaws in the securitisation market, such as the ones that led to the "sub-prime" crisis, and to help alleviate the stigma on the most simple, standardised and transparent securitisation products. Such an initiative should be considered in the context of broader reforms affecting securitisation markets in recent years, eg. on credit rating agencies and risk-retention rules.

Further details are available in section 7.5 of EIOPA's report.

A) Structural features

- **Maximum seniority** – the tranche is not subordinated to any other tranches
- **Legal true sale and absence of severe clawback provisions** – the special purpose vehicle must hold the full rights to the assets, even in case of insolvency of the seller of the underlying assets (originator or sponsor). This is intended to secure as much as possible investors' claims on the vehicle.
- **Servicing continuity** – there should be a plan to ensure continuity in the event of default of the servicer (i.e. administration, collection and recovery) or of another counterparty providing liquidity or hedging to the vehicle.

B) Asset class eligibility and underlying characteristics

²⁰⁸ COM(2014)168 final, adopted on 27 March 2014

²⁰⁹ Joint ECB-BoE paper "The impaired EU securitisation market: causes, roadblocks and how to deal with them" released on 11 April 2014 (<http://www.bankofengland.co.uk/publications/Documents/news/2014/paper070.pdf>)

²¹⁰ EIOPA report (December 2013) available on: http://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments_2_.pdf

- **Eligible underlying assets** – only the following assets are allowed: residential mortgages loans or residential fully guaranteed loans, loans to SMEs, auto loans and leases, consumer loans and credit card receivables. In particular, loans to larger corporates -giving rise to credit linked obligations (CLOs)- and commercial mortgage loans -giving rise to CMBS- are not eligible for high-quality, given their complexity and poorer credit performance according to EIOPA. Resecuritisations are not allowed.
- **Homogenous cash flows** – only one type of eligible underlying asset is allowed in each transaction, to reduce complexity.
- **Restricted use of derivatives** – underlying assets can only include derivatives if these are used to hedge currency risk or interest rate risk. In particular, credit derivatives such as credit default swaps (CDS) are not allowed in order to exclude synthetic securitisation from the high quality category.
- **Minimum rating requirements** – the tranche must be allocated to credit quality step 3 or better (investment grade) at issuance and at any subsequent point in time to remain eligible as high quality.
- **No credit impairment** – excludes assets for which at origination the credit history of the borrower raises doubts that payments will be made in full (this effectively excludes "sub-prime" lending).
- **No non-performing loans** – no loan should already be in default at the time it is incorporated into the pool of assets in the vehicle.
- **At least one payment** – at least one payment has been made by the borrowers on the loans (this excludes securitisations based only on newly originated loans).

C) Listing and transparency features

- **Listing requirement** – the securitisation must be admitted to trading on a regulated market in the EEA or OECD, or on other robust market infrastructure.
- **Transparency, reporting and disclosure requirements** – very granular data on the assets underlying the securitisation must be disclosed, in order for actual and potential investors to be in a position to conduct comprehensive and well informed due-diligence and stress tests.

D) Underwriting process

- **No self-certification** – in the case of residential loans, information about the borrower must be checked by the lender (this also contributes to excluding "sub-prime" lending)
- **Process for assessing creditworthiness** – assessments of the borrowers' credit worthiness must meet requirements set out in the Mortgage Credit Directive (2014/17/EU) or in the Consumer Credit Directive (2008/48/EC) or equivalent requirements outside the Union.

Recent reforms contributing to safe and sustainable securitisation markets in the EU

Since the beginning of the last financial crisis, a number of important reforms have affected securitisation markets, which can be summarised as follows:

- credit rating agencies are now regulated and subject to supervision by the European Securities and Markets Authority, who is tasked with setting up a detailed, public database of securitisation transactions in the Union;
- risk-retention rules, requiring the originator or sponsor to keep a substantial economic interest in the assets being securitised, are in place in all financial sectors (banking, (re)insurance and investment funds) to avoid the development of "originate to distribute" business models.

In details, the following pieces of EU legislation have profoundly changed securitisation markets in recent years:

- Commission Regulation 809/2004 implementing Directive 2003/71/EC (the "Prospectus Directive") requires specific information for issuers of and for securities linked to or backed by an underlying asset;
- Directive 2009/138/EC (the "Solvency II Directive") ensures cross-sectoral consistency by enforcing retention rules and qualitative requirements, including reporting and disclosure, that must be met by insurers and reinsurers investing in securitisation;
- On 27 October 2010, the Financial Stability Board published "Principles for reducing reliance on CRA ratings"²¹¹ in which issuers of securities are requested to disclose comprehensive, timely information that will enable investors to make their own independent investment judgements and credit risk assessments of those securities. In the case of publicly-traded securities, this should be a public disclosure;
- On 16 December 2010, the European Central Bank decided to establish loan-by-loan information requirements for asset-backed securities (ABSs) in the Eurosystem collateral framework²¹². The ABS loan-level requirements provide market participants information on the underlying loans as well as their performance in a timely and standardised manner;
- Regulation 462/2013 of 21 May 2013 amending Regulation 1060/2009 on credit rating agencies (CRA3) has introduced a number of new disclosure obligations for issuers, originators and sponsors with respect to structured finance instruments. The scope of the disclosure requirements included in Article 8b of the CRA3 covers a wide range of securitisation transactions;
- Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR) introduced disclosure obligations for originators and sponsors of securitisation transactions and due diligence obligations for investors;
- Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR) also includes reporting requirements related to own funds which cover securitisation transactions (CRR Article 99) and reporting requirements related to asset encumbrance (CRR Article 100);

²¹¹ http://www.financialstabilityboard.org/cos/cos_101001.htm

²¹² <http://www.ecb.europa.eu/paym/coll/loanlevel/transmission/html/index.en.html>

- Commission Delegated Regulation 231/2013 supplementing Directive 2011/61/EU (AIFMD Level 2 Regulation, article 56) introduced rules with respect to the risk retention and due diligence requirements for alternative investment fund managers (AIFMs) seeking to invest in securitisations;
- Directive 2011/61/EU (the "AIFM Directive") amended Directive 2009/65/EC (UCITS Directive) in order to provide for an empowerment for the Commission to adopt rules with respect to the risk retention and due diligence requirements for UCITS seeking to invest in securitisations including stress tests requirements. It is currently envisaged that ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (Final report (ESMA/2011/379)) would apply all the requirements set out in the advice for AIFMs to UCITS assuming exposure to the credit risk of a securitisation position according to the limits of the UCITS Directive.

ANNEX 6. RELIANCE ON EXTERNAL RATINGS FROM CREDIT RATING AGENCIES

A) Where are external credit assessments used in Solvency II ?

Solvency II is a fully risk-based prudential regime under which an undertaking's Solvency Capital Requirement (SCR) can be calculated using either a standard formula or a full or partial internal model approved by supervisors.

The standard formula for calculating the SCR captures credit risks in the spread risk, market risk concentrations and counterparty default risk modules and sub-modules. For these risk modules and sub-modules, the Delegated Acts use external credit assessments from Credit Rating Agencies (CRAs) to determine the applicable risk factors for each exposure in the SCR calculation. Under Solvency II, insurers are free to invest in any asset provided that the investment is in the interests of policyholders and insurers are able to identify, measure, monitor, manage, control and report the risks associated with those investments. Therefore, investments are not limited to assets of a certain credit quality, only different risk factors will apply to their assets depending on their credit quality.

Besides, the provisions in the Delegated Acts pertaining to the recognition of risk mitigation techniques, such as reinsurance, involve external credit assessments to the extent that it is not possible to assess the financial soundness of the reinsurance counterparty by virtue of their compliance with Solvency II or equivalent solvency requirements.

Given that their primary business is to underwrite insurance risk, insurers and reinsurers (particularly non-life insurers) do not have the same expertise and information to assess credit risk as banks do. Therefore, it would be disproportionate to require users of the standard formula to develop their own internal credit assessments for all their investment and reinsurance exposures, particularly since the standard formula users tend to be the smaller and less complex undertakings. Lastly, one of the goals of Solvency II is to ensure harmonisation of prudential regulation across the EU, which requires a uniform approach to measuring credit risk.

Therefore, the Commission considers that the limited reliance on external credit ratings from CRAs that is embedded in the Delegated Acts in the areas described above is justified. In addition, a number of safeguards to avoid mechanistic reliance on CRAs have been included, in the Directive and in the Delegated Acts.

B) Safeguards to avoid mechanistic reliance on external credit ratings

In line with the Financial Stability Board's "Principles for Reducing Reliance on CRA Ratings", endorsed by G20 Leaders in November 2010²¹³, the Delegated Acts for Solvency II include specific provisions to ensure that the objective of avoiding overreliance on credit rating agencies is achieved:

- Insurers and reinsurers are required to have their own internal credit assessment for their larger or more complex exposures. Out of the internal credit assessment and the external credit rating, only the most prudent assessment, measured with respect to the capital requirements generated, is retained and where there is only one external rating available for a securitisation exposure, the exposure is considered unrated;

²¹³ See http://www.financialstabilityboard.org/cos/cos_101001.htm

- Exposures to securitisations which do not qualify as "high quality" according to the criteria recommended by EIOPA and explained in Annex 4 are classified as "larger or more complex exposures" of insurers and reinsurers and therefore require an own internal credit assessment, supplementing those from CRAs if it is more conservative;
- Explicit provisions to limit the use of external ratings in the risk management of insurers have been introduced, such as:
 - external ratings shall not prevail in risk management;
 - as part of their investment risk management policy, insurers and reinsurers should have their own assessments of all counterparties;
 - as part of their reinsurance (or other risk mitigation techniques) policy, insurers and reinsurers should have their own assessments of all counterparties.

More generally, the Commission has launched a number of cross-sectoral initiatives to reduce reliance on CRAs. The latest amendment of the regulation on credit rating agencies²¹⁴ hereafter referred to as the CRA III regulation) has introduced a general obligation (article 5a) for financial institutions, including insurance and re-insurance undertakings to make their own credit risk assessment and not solely or mechanically rely on credit ratings for assessing creditworthiness of an entity or a financial instrument. Furthermore, the same article requires competent authorities of such undertakings, taking into account the nature, scale and complexity of their activities, to monitor the adequacy of their credit risk assessment process, assess the use of contractual references to credit ratings and, where appropriate, encourage the mitigation of such references, with a view to reducing sole and mechanistic reliance on credit ratings, in accordance with specific sectoral legislation.

In addition, the CRAIII regulation (article 5b) requires the European Supervisory Authorities, including EIOPA, not to refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by competent authorities, financial institutions or other financial market participants. On 6 February 2014, the three European Supervisory Authorities, including EOIPA, released a report on the reliance on external credit ratings in their guidelines and recommendations²¹⁵.

Furthermore, the CRAIII regulation (article 5c) requires the Commission to continue reviewing references to ratings in Union law which trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by competent authorities or financial market participants, with a view to deleting provisions of Union law that require or allow the use or issue of credit ratings for regulatory purpose by January 2020, provided that appropriate alternative credit risk assessments have been identified and implemented.

ANNEX 7. GLOSSARY

Alternative investment funds	Funds subject to Directive 2011/61/EC (the AIFM Directive). AIFs are collective investment vehicles which are not UCITS.
Bucket	When calculating the SCR according to the standard formula,

²¹⁴ Regulation 1060/2009 on credit rating agencies, as amended by Regulation 462/2013

²¹⁵ <https://eiopa.europa.eu/home-news/news-details/news/eba-esma-and-eiopa-publish-final-report-on-mechanistic-references-to-credit-ratings-in-the-esas-1/index.html>

	insurance and reinsurance undertakings are required to breakdown their portfolio into different asset classes, to which risk factors are allocated. In this report, these classes are referred to as "buckets".
CEIOPS	CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) is the predecessor of EIOPA. It provided extensive advice to the Commission in drafting the delegated acts, on the basis of publicly consulted discussion papers. CEIOPS was replaced by EIOPA on 1.1.2011.
CRD IV	Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms,
CRR	Regulation 575/2013/EU on prudential requirements for credit institutions and investment firms
Directive	A legislative act of the European Union, which requires Member States to achieve a particular result without dictating the means of achieving that result. A Directive therefore needs to be transposed into national law contrary to regulation that have direct applicability.
EIOPA	<p>EIOPA is the European Insurance and Occupational Pensions Authority, which replaced CEIOPS on 1 January 2011 in the context of European System of Financial Supervision. It is an It is an independent advisory body to the European Parliament, the Council of the European Union and the European Commission.</p> <p>EIOPA's core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries.</p>
ELTIF	European Long Term Investment Fund. Specific category of alternative investment funds which the Commission proposed to create in June 2013 (see COM 2013(462)) in order to set up a labelled, standardised vehicle for long term investment.
EVCF	European Venture Capital Fund. These are specific collective investment vehicles subject to Regulation 346/2013(EU), designed to foster venture capital investment in Europe.
ESEF	European Social Entrepreneurship Fund. These are specific collective investment vehicles subject to Regulation 345/2013(EU), designed to foster investment in social businesses in Europe.
Financial Stability Board (FSB)	It brings together national financial authorities and international standard setting bodies to coordinate, develop and promote the implementation of effective regulatory, supervisory and other financial sector policies at an international level. The FSB was mandated by the G20 Leaders to promote financial stability.
GAAP	Generally accepted accounting principles. This acronym is used to refer to accounting rules in force in Member States, which may be different from IFRS standards, which are only compulsory in the EU for consolidated statements of listed companies.
Hedging	The practice of offsetting an entity's exposure by taking out another opposite position, in order to minimise an unwanted risk.

	This can also be done by offsetting positions in different instruments and markets.
IFRS	International Financial Reporting Standards. They are prepared by the International Accounting Standards Board and can be endorsed by the Commission, incorporated into EU law via a regulation.
Interest rate swap	A financial product through which two parties exchange flows; for instance, one party pays a fixed interest rate on a notional amount, while receiving an interest rate that fluctuates with an underlying benchmark from the other party. These swaps can be structured in various different ways negotiated by the counterparties involved.
Liquidity	A complex concept that is used to qualify market and instruments traded on these markets. It aims at reflecting how easy or difficult it is to buy or sell an asset, usually without affecting the price significantly. Liquidity is a function of both volume and volatility. Liquidity is positively correlated to volume and negatively correlated to volatility. A stock is said to be liquid if an investor can move a high volume in or out of the market without materially moving the price of that stock. If the stock price moves in response to investment or disinvestments, the stock becomes more volatile.
LTGA	Long-term guarantees impact assessment. This is the last of the six quantitative impact studies carried out by EIOPA in 2013. It was requested by trilogue parties to inform Omnibus II negotiations on measures designed to avoid artificial volatility on insurers' balance sheet. LTGA results were published in June 2013 by EIOPA (available on http://eiopa.europa.eu) and helped successfully close the political negotiations on Omnibus II.
Mark-to-market, or market-consistent valuation	Accounting for the value of an asset or liability based on the market prices, as opposed to historical cost accounting. The value of an asset or liability therefore fluctuates in accordance with the changes in market conditions.
MCR	Minimum Capital Requirement. This is the absolute minimum capital that an insurance or reinsurance undertaking must hold under Solvency II, calibrated on a 85% value-at-risk benchmark (i.e. lower than the SCR). If the MCR is breached, it triggers ultimate intervention by the supervisory authorities and compliance must be restored within three months (see article 128 and ff. and article 139 of Directive 2009/138/EC).
OECD	The Organisation for Economic Co-operation and Development is an international economic organisation of 34 countries founded in 1961 to stimulate economic progress and world trade.
Omnibus II	The original purpose of this directive proposed by the Commission in January 2011 (COM/2011/0038 final) was to operationalize the powers of the newly-created EIOPA, but the proposal was used to introduce substantive modifications to Solvency II during Council and Parliament discussions. It took nearly three years of negotiations until a carefully balanced package of several measures was agreed in November 2013, in particular a package of measures to assist insurers to continue to provide insurance products with long-term guarantees, by avoiding artificial volatility on their balance sheet.

ORSA	Own risk and solvency assessment. As part of the system of governance of the Solvency II regime, undertakings shall perform an ORSA regularly and without any delay following any significant change in their risk profile.
Private equity	Private equity strictly means any equity of a company which is not publicly traded on a stock exchange, irrespective of the size or activity of the company. In a narrower meaning, "private equity" is a synonym for venture capital, i.e. equity financing of SMEs and start-ups.
QIS	Quantitative Impact Studies. Between 2005 and 2013, CEIOPS (and then EIOPA) carried out six QIS to inform both the development of the Solvency II Directive (proposed by the Commission in 2007 and agreed in 2009) and then the Omnibus II directive and the draft Delegated Acts.
Regulation	A form of European Union legislation that has direct legal effect on being passed in the Union.
SCR	Solvency Capital Requirement. This is the main capital requirement for insurance and reinsurance undertaking under Solvency II. It is calibrated on a 99.5% value-at-risk benchmark (i.e. higher than the SCR) and can be calculated on the basis of a standard formula or internal models developed by undertakings and approved by supervisory authorities. Breach of the SCR is the first step of supervisory intervention (see article 100 and ff. and article 138 of Directive 2009/138/EC).
Securitisation	Transaction which purpose is to create securities whose value and income payments are derived from and collateralised by a specified pool of underlying assets –lodged in a special purpose vehicle– which can be receivables, such as mortgages, credit cards receivables, auto loans, etc.
Solvency I	Solvency I is used as a general term to refer to the set of 14 directives currently applicable in the insurance and reinsurance sector (including a directive dating back to 1973), which will be replaced by the Solvency II directive, as amended by Omnibus II, on 1.1.2016.
Solvency II	Solvency II is the name given to Directive 2009/138/EC, as modified by the Omnibus II directive. Solvency II introduces a modern risk-based prudential regime that will replace Solvency II on 1.1.2016.
Spread	The spread on a debt instrument (bond or loan) is the difference in yield between this instrument and a risk-free interest rate, reflecting the credit risk faced by an investor buying this instrument. The spread therefore reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk. The spread of a given debt instrument fluctuates over time, reflecting changes in liquidity and in investors' perception of credit risk.
Undertakings for Collective Investment in Transferable Securities Directives (UCITS)	Undertakings for Collective Investment in Transferable Securities Directive, a standardised and regulated type of collective investment vehicle, subject to Directive 2009/65/EC.
Value at Risk (VaR)	Value-at-risk is the risk measure prescribed in Solvency II. The SCR must be calibrated on the 99,5% VaR of own funds over a

	one year horizon, which means that the SCR is a buffer that can absorb the worst possible loss faced by an undertaking in any given year, with a 99,5% level of confidence.
Volatility	The change in value of a certain variable (price, interest rate...) in a period of time.