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KPMG Analysis and key findings: EIOPA Draft Guidelines on Solvency II – first set of consultation papers

EIOPA issued its first set of draft Solvency II Guidelines in June this year. The Guidelines are set out in five papers and include around 500 individual guidelines. Although addressed to national competent authorities (NCAs), they have a direct impact on authorised (re)insurers. The devil is in the detail, of course, but this paper sets out our key findings and summarises the key changes and clarifications from the previously published Solvency II texts.

In some areas, further detail will need to follow, presumably in the second set of Guidelines due to be released in December 2014. However, the material will help all firms move forward with their Solvency II preparations for go live on 1 January 2016. The short consultation period and size of the papers have meant that not all firms had sufficient time to identify all matters relevant to them.

In this paper we raise some important considerations that will need to be addressed. Please contact Janine Hawes or Nick Ford for assistance if you require further information about the potential impacts.

KPMG's summary of the key findings for each of the consultation papers are as follows:

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Consultation Paper on the proposal for Guidelines on Solvency II relating to Pillar 1 requirement

Pillar 1: Technical provisions (99 Guidelines)

The guidelines cover a wide range of areas, including contract boundaries, data quality, segmentation and unbundling, assumptions, calculation methodologies and validation. EIOPA provide helpful guidance and examples, but most of the material is not new. There are areas where further clarification will be required, for example the derivation of the discount rate curve. Notwithstanding this, these Guidelines should prevent the need for significant reworking.

Areas that we found particularly interesting are:

- *Contract boundary:* A key addition is that a discernible benefit on a contract is one where the benefit gives a 'truly improved contract for the policyholder' compared to one without the benefit. There is no view expressed as to how significantly improved this must be, so it could be read that NCAs will accept that any unit linked contracts that give a claim payout above the unit value will be able to include future premiums in the valuation of these contracts. However, this is an area where, potentially, the guidelines have increased uncertainty rather than reduced it.
- *Data quality:* Whilst accepting that expert judgement must play a part in addition to data collection, the guidelines are clear that it must supplement and not replace appropriate data collection methods. Guidance is provided regarding the role of the actuarial function in identifying and dealing with data weaknesses.
- *Assumptions:* Guidance provided on the modelling approach to biometric risks. Confirmation that future shareholder transfers do not form part of technical provisions.
- *Proportionality:* Guidance is provided regarding how 'nature', 'scale' and 'complexity' should be interpreted, which should facilitate agreement in this difficult area between firms and their NCA. It is also confirmed that simplifications can be applied for the purposes of determining the quarter end technical positions for regulatory reporting purposes, although analyses of the reasonability and accuracy of those simplifications must be performed for life insurance business.
- *Market risk in risk margin:* It is suggested that this should capture the basis risk within existing hedging programmes. Theoretically, this seems counter-intuitive as firms without a hedging programme will determine the risk margin on the basis that if the portfolio were to be transferred the new company would hedge (without any basis risk), but firms currently operating a hedging programme must assume that the basis risk also transfers.
- *Economic scenario generators (ESGs):* The ongoing appropriateness of ESG must be demonstrated, with a number of tests specified to be performed, including comparison of simulated and historical correlations and sensitivity analysis regarding the impact of changes to the calibration parameters, which may be new for some firms.
- *Validation:* The draft delegated acts include a requirement for an annual validation of technical provisions, and the Guidelines provide clarity regarding the process to be adopted, covering both quantitative and qualitative elements. In particular, any significant deviations between actual and expected experience should be investigated to understand the underlying reasons and consider if it is temporary or if the assumptions/model should be amended.

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Consultation Paper on the proposal for Guidelines on Solvency II relating to Pillar 1 requirement (cont.)

Pillar 1: Own Funds (56 Guidelines)

The guidelines cover four aspects of own funds: ancillary own funds, classification, ring-fenced funds and the treatment of related undertakings, including participations. Taken together with the draft delegated acts, there is little new in the Guidelines.

Areas that we found particularly helpful are:

- *Freedom from encumbrances*: new guidance provided, recognising that some encumbrances can lead to the downgrading of own fund items to a lower tier of own funds, whilst others may render the item as ineligible for any tier. Guidance is also provided regarding loss absorbency and incentives to redeem.
- *Own funds transitional measures*: Consistent with the draft delegated acts, grandfathered tier one capital must be included within the 20% of total tier one capital limit (which also applies to preference shares, subordinated liabilities and subordinated mutual member accounts).
- *Called up, but not paid in capital*: Clarification that EIOPA expects that any such capital will only count as own funds for a maximum of three months, during which time it should be classified as tier two own funds.
- *Strategic participations*: Guidance on the evidence required to demonstrate materially less volatile equity prices, the participation's strategic nature and the existence of a durable link. It should also be noted that collective investment schemes and similar investments that qualify as related undertakings under IFRS due to the percentage of units held should not be classified as a strategic participation solely on this basis.
- *Ring-fenced funds (RFF):* Confirmation that future shareholder transfers from a RFF can be used towards the firm's SCR (provided the corresponding policyholder distributions are included in the best estimate liabilities). EIOPA also confirm that there is no requirement for the RFF to cover notional SCR. Finally, it is worth noting that most of the Guidelines in this section also apply to any matching adjustment portfolio.

Some firms may find the need to identify the effects of non-diversification in their reporting of the SCR by risk modules challenging.

Pillar 1: Standard Formula SCR (115 Guidelines)

The guidelines in this area cover a range of items: application of the look-through approach, basis risk, outwards reinsurance arrangements (non-life), market and counterparty risk, underwriting risk modules, loss-absorbing capacity (LAC) of technical provisions and deferred taxes and finally the use of undertaking-specific parameters (USP). Much of the new material relates to non-life firms.

Areas that we found particularly helpful are:

- *Look-through approach:* Confirmation that sufficient iterations should be performed to enable the material underlying risks to be identified. This is likely to result in different approaches being adopted by firms depending both on the materiality of the investment and the complexity of its underlying exposures. Money market funds and catastrophe and longevity bonds (that do not qualify as risk-mitigation techniques) are all in scope.
- *Basis risk:* There are practical examples of what constitutes significant basis risk. However, we believe the specific tests that need to be demonstrated before risk-mitigation techniques can be applied are potentially onerous.
- *Outwards reinsurance arrangements (non-life):* This is new material, and relates to outwards reinsurance arrangements to the non-life catastrophe risk sub-module. Insurers will need to revisit their approach to netting down to ensure it complies with the Guidelines.
- *Loss-absorbing capacity (LAC):* Confirmation that the calculation of LAC of technical provisions can be performed without two sets of stress tests. However, we are concerned that the LAC of deferred taxes will only be permitted to the minimum of the standalone benefit and the benefit available though tax grouping, effectively eliminating the benefit of group relief.
- *Undertaking-specific parameters (USP):* This is new material, supporting that included in the draft delegated acts and the application process set out in the recent draft implementing technical standard. There is an important clarification that compliance with the USP requirements should be monitored as part of the ORSA process and the supervisor must be informed of any changes that impact the appropriateness of the USPs. Additional Guidelines are included relating to specific requirements for group USPs.

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Consultation Paper on the proposal for Guidelines on Solvency II relating to Pillar 1 requirement (cont.)

Pillar 1: Groups (36 Guidelines)

The guidelines cover: the scope of the group, group solvency calculation levels, calculation methodology, availability of group own funds, minimum group SCR (Accounting consolidation basis) and application of group capital add-ons.

There are some very significant changes introduced by the Guidelines that will affect firms' approach to the group requirements. Whilst some offer a pragmatic solution, others appear to introduce further uncertainty. The most significant points we noted are as follows:

- *Layers at which group solvency calculations will be required:* Article 213 sets out four levels at which some form of group supervision will be required, which the Guidelines confirm are not mutually exclusive. However, the Guidelines indicate that supervisors should 'consider' the application of group supervision at several layers of the group, with the default position being supervision at the EEA level.
- *EEA sub-group of equivalent worldwide group:* Despite this being described as the default level, supervision at this level may be waived (on a case by case basis) if certain conditions, including equivalent worldwide group supervision, are met. Article 215 does not offer this possibility and Article 260 specifically refers to worldwide group supervision, so it had not previously been clear whether this was possible. However, this approach would be consistent with the optionality inferred by EIOPA above and will a welcome relief for Bermuda and Swiss groups. What remains unclear is whether this will also be applicable to groups benefitting from the temporary groups equivalence transitional arrangement.
- *Non-equivalent worldwide group:* Article 262 requires group supervision on either a mutatis mutandis basis or through applying 'other methods'. However, the guidelines are unclear as to whether the mere existence of an EEA subgroup would be sufficient of itself to remove the threat of group supervision at the worldwide level. We suspect that supervisors will want to understand the overall group solvency position, even if on a local basis, potential threats to this and the level of interconnectivity between the EEA subgroup and the rest of the group before deciding on the approach.
- *Contribution of non-EEA insurers to group solvency:* The Guidelines introduce a lack of clarity regarding whether these can generate a solvency contribution. Guideline 20 states that any legal or regulatory restriction would result in all of the entity's own funds being deemed non-available, with inclusion of own funds only to the level of its contribution to the group SCR. This seems unduly penal and we believe that the excess over the restricted amount should be eligible to contribute towards group solvency. We remain hopeful that this is a simple drafting error that will be corrected and not the intended policy.
- *Minimum group SCR:* Where the accounting consolidation basis is applied, Article 230 requires that the group SCR shall not be less than the sum of the solo minimum capital requirements (MCR) of the insurance entities in the group. The Guidelines confirm that this includes insurance holding companies (ultimate and intermediate) which will be required to determine a notional SCR, with the MCR being taken as 35% of that SCR. We are concerned that this could artificially inflate the group SCR floor, due to the equity charge against their investment in (re)insurers that are already contributing to the SCR floor. This would be removed if the notional SCR were determined excluding investment in insurance entities, but the drafting does not currently permit this.

It is worth noting that there is an explicit requirement introduced for group instructions and guidance to be shared and for ensuring compliance with these, as well as a requirement to include an assessment of the non-available own funds for all the undertakings included in the calculation of the group solvency, together with an explanation of the adjustments made, within the group regular supervisory report.

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Consultation Paper on the proposal for Guidelines on the Use of Internal Models

Most of the Guidelines are conversions of the preparatory phase guidelines and EIOPA have helpfully highlighted material that is new, with just 10 new guidelines. The majority of changes relate to the provision of more clarity regarding the use of a group internal model by individual entities within the group. Generally, the guidelines provide helpful practical details on how to meet the requirements.

Areas that we highlight are:

- *Model change policy:* Confirmation that changes to assumptions are in scope of the model change policy will be an unwelcome development for those firms that have sought to exclude these. Changes, and their impact, will therefore need to be reported to the NCA, with major changes (which could arise from a series of minor changes) requiring prior approval before being implemented.
- *Multiple models:* Firms will not be able to demonstrate that they meet the use test if they have one modelling framework for making internal decisions and another for calculating regulatory capital. There are a number of helpful examples of evidence of use, including good and bad practice which should help firms compare against their own approach.
- *Model validation:* EIOPA provide a helpful clarification on what 'independence' means for model validation. For smaller firms, having separate reporting lines is acceptable. Independent validation also means being able to show independent challenge – otherwise it is difficult to attach credibility to the validation.
- *External data/models:* Firms need to ensure that documentation of external models and data meets the Solvency II requirements, which can be difficult to demonstrate where firms have no control over third party documents. Firms may need to write their own supplementary documents, but the challenge then is how they source the information from the third party.
- *Use of group internal model for solo purposes:* Greater clarity is provided on the evidence required in respect of the solo entity position, such as differences in the treatment of intra-group transactions, model parameters and group specific risks.

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Consultation Paper on the proposal for Guidelines on system of governance and own risks and solvency assessment (ORSA)

The ORSA elements of this paper replicate almost entirely the preparatory phase guidelines, with the exclusion of material that has no relevance outside the preparatory phase. The system of governance section is a mix of preparatory phase guidelines and new material (28 new Guidelines plus some additions into others).

Key elements of the new governance Guidelines are:

- *Valuation of other (non-insurance related) assets and liabilities:* This is an entirely new section of the Guidelines and deals with valuation policies, data quality, assessment of less active markets and when alternative valuation methods should be used, documentation (including key assumptions and limitations), internal review and verification of valuation methods used (internally developed and externally sourced) and Board oversight. It is worth highlighting the NCAs' ability to request independent valuation or verification at least when there is a risk of misstatements in the valuation of material assets or liabilities that could impact the firm's solvency position.
- *Remuneration:* A firm's remuneration policy and the construct and role of the remuneration committee are new areas. This includes requiring alignment of the remuneration policy with risk strategy and ensuring this does not reward excessive risk-taking or failure and that it could not threaten the maintenance of an adequate capital base.
- *Actuarial function:* An explicit requirement to report material deviations between actual experience and the projected best estimate to the Board, identifying the causes and proposing evidence-based changes to the assumptions and modifications to the valuation model in order to improve the best estimate calculation.
- *Capital management policies:* These must now explicitly address future dividend policy, considering the link with the foreseeable dividends deduction required from own funds, and document where distributions could be cancelled or deferred.
- *Prudent person principle:* Extension to cover the assessment of the security of their investment portfolios in normal and stressed conditions, assessment of investment profitability and availability of assets and the management of conflicts of interest.
- *Group specific requirements:* New requirement to maintain processes and procedures to avoid concentration of risks that could be a threat at group level and enable the monitoring and reporting of intra-group transactions. There is also new guidance in the risk management section regarding the monitoring of strategic and reputational risks and correlations with other risk.
- *Internal audit:* Additional guidance relating to conflicts of interest, staff rotation, the internal audit plan and documentation.

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Consultation Paper on the proposal for Guidelines on Supervisory Review Process

The aim of this paper is to ensure that all NCAs adopt a risk-based, prospective and proportionate approach to supervision. There has been no public guidance in this area previously. The guidance is quite high level and unlikely to offer many surprises to the NCAs.

Whilst this paper is aimed at the national competent authorities (NCAs), firms may find the insights into the supervisory processes helpful, although it should be noted that there is a significant amount of supervisory discretion. However, probably the most important thing for firms to consider is how they will handle information requests from the various NCAs and ensure that they can respond on a timely basis and that there is consistency of approach throughout the group.

The three required elements of the supervisory review process, which should be applied consistently (subject to the proportionality principle and supervisory discretion dependent on the perceived risks) are as follows, and there should be effective communication, both with the authorised firm or head of the insurance group and fellow members of the college of supervisors:

- *Risk assessment framework:* This should be risk-based and forward-looking and consider both the current and future risks faced and assess the firm/group's ability to manage and report those risks. This will then influence the frequency of reporting by the firm, supervisory priorities and creation of a supervisory plan, taking account of both its risk and impact assessment.
- *Detailed review:* This includes both on-site and off-site work, depending on the supervisory plan, focussing on the areas of risk identified in the risk assessment framework. Firms should be given sufficient time to respond to findings and requests for additional information.
- *Supervisory measures:* This should be based on the findings from the detailed review stage and aim to address perceived weaknesses and actual or potential areas of non-compliance. Actions proposed should depend on the significance of the area of concern and must be notified to the firm in writing along with the actions required and timeframe for compliance. The NCA must also then monitor whether these have been effected properly and update the supervisory plan accordingly.

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Consultation Paper on the proposal for Guidelines on the methodology for Equivalence Assessments by National Supervisory Authorities under Solvency II

This paper will only apply where the Commission has not decided either way on the equivalence of the country concerned and a group supervisor is undertaking its own equivalence assessment, either on its own initiative or at the request of the firm/group. This relates to all three aspects of equivalence (reinsurance placed (Article 172), inclusion of a non-EEA insurance entity within a group solvency calculation on a local basis (Article 227) and overall group supervision (Article 260).

Most of the paper comprises the technical aspects that need to be completed to support the Article 227 and 260 assessments, including the questionnaires to be completed by the relevant third country supervisory authority. These aim to ensure consistency with the process adopted for the Commission assessments. The process involves both communication with EIOPA and other NCA, since once a group supervisor reaches a determination on the equivalence status of a third country regime, it effectively becomes binding on all other NCA. For this reason, the assessment must be undertaken in relation to the system as a whole and other NCA have the ability to object to the conclusion reached.

Positive equivalence assessments will need to be reviewed at least every three years or upon significant changes in the local regulatory regime.

The paper appears to only deal with 'full' equivalence assessments as it states that proposed changes to that country's supervisory regime cannot be taken into account in the equivalence assessment process until they are implemented. This suggests there may be a further paper to come dealing with the temporary and provisional equivalence transitional measures introduced through the Omnibus 2 amendments.

EIOPA's comment that the 'active cooperation of the third country supervisor is determinative' in assessing group equivalence, together with an assessment process will take many months and could easily extend to a year or more, suggests that we will see very few NCA assessments performed.

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