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Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

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Mr Gabriel Bernardino
Chairman
EIOPA
Westhafenplatz 1
60327 Frankfurt am Main
Germany

Subject: Formal request to EIOPA for technical advice on Solvency II implementing measures

Dear Mr Bernardino, Dear Gabriel,

Between September 2015 and January 2016, the Commission conducted a public consultation in which inviting all interested parties to provide feedback and empirical evidence on the benefits, unintended effects, consistency and coherence of the financial legislation adopted in response to the financial crisis (the Call for Evidence). This initiative will help the Commission to assess the efficiency, consistency and coherence of the overall EU regulatory framework for financial services.

Solvency II, which fully entered into application on 1 January 2016, was identified as one area where significant improvements could be achieved, in the areas of simplification, technical consistency and impact on long-term investments. Considering that the Commission intends to review the standard formula by 2018, technical work should start as soon as possible to ensure that appropriate solutions are found.

I am pleased to enclose a Call for Advice with this letter, focusing on two of our three priorities for this review: proportionate and simplified application of the requirements, and removal of unintended inconsistencies. Additional internal work within DG FISMA will be conducted on the removal of unjustified constraints to financing, to identify precisely how the review could help to achieve this objective. EIOPA's technical advice may be requested in this area at a later stage.

To ensure a timely review of Solvency II implementing measures, I would invite EIOPA to provide its final technical advice, including a cost-benefit analysis, by 31 October 2017. However, where necessary, a staggered approach could be adopted and partial advice submitted before the submission of the final advice. I would be grateful if you could share with us your timetable to answer this request.

I believe that close co-operation between EIOPA and the Commission on this matter should be maintained. To this end, I would propose that representatives of DG FISMA should participate, as an observer, in meetings / conference calls related to this technical advice.

Yours sincerely,

Olivier Guersent

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Enclosures: REQUEST TO EIOPA FOR TECHNICAL ADVICE ON THE REVIEW OF SPECIFIC ITEMS IN THE SOLVENCY II DELEGATED REGULATION (Regulation (EU) 2015/35)

Electronically signed on 18/07/2016 12:27 (UTC+02) in accordance with article 4.2 (Validity of electronic documents) of Commission Decision 2004/563

REQUEST TO EIOPA FOR TECHNICAL ADVICE ON THE REVIEW OF SPECIFIC ITEMS IN THE SOLVENCY II DELEGATED REGULATION (Regulation (EU) 2015/35)

With this mandate to EIOPA, the Commission seeks EIOPA's technical advice on the review of specific items in the Solvency II Delegated Regulation (Regulation (EU) 2015/35).

The mandate follows the Communication from the Commission to the European Parliament and the Council – Implementation of Article 290 of the Treaty on the Functioning of the European Union (the "**290 Communication**")[1], the Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority (**the EIOPA Regulation**)[2], the Framework Agreement on Relations between the European Parliament and the European Commission (the "**Framework Agreement**")[3] and the inter-institutional agreement on better law-making[4].

The Commission has expressed its intention to review the methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement with the standard formula before December 2018. This review should make use of the experience gained by insurance and reinsurance undertakings during the transitional period and the first years of application of Solvency II. EIOPA is invited to provide technical advice on specific items that the Commission has identified for the scope of this review.

This technical advice shall be delivered by 31 October 2017. However, where necessary, a staggered approach could be adopted and partial advice submitted before the submission of the final advice.

1. Context

1.1 Scope

On 18 January 2015, Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) entered into force. In this Regulation, the Commission executed 76 empowerments set out in Directive 2009/138/EC. When that Regulation was adopted, the Commission expressed its intention to review specific items of the Solvency II standard formula before December 2018[5].

On 30 September 2015, the Commission launched a call for evidence on the EU regulatory framework for financial services. 50 respondents from the insurance sector participated in this exercise, comprising industry, public authorities and non-governmental organisations. The call for evidence provided further insights into the functioning of the Solvency II framework, and based on that input, the following areas merit further reflection:

I. Proportionate and simplified application of the requirements

Solvency II replaced 28 national regimes by a single risk-based framework. According to Article 29(4) of the Solvency II Directive, the delegated acts and the regulatory and implementing technical standards adopted by

[1] Communication of 9.12.2009. COM(2009) 673 final.
[2] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), OJ L 331, 15.12.2010, p. 48–83.
[3] The Framework Agreement on relations between the European Parliament and the European Commission, OJ L304/47, 20.11.2010, p.47.
[4] Inter-institutional agreement between the European Parliament, the Council of the European Union and the European Commission of 13 April 2016 on Better Law-Making, OJ L 123, 12.5.2016, p.1.
[5] Recital 150 of Commission Delegated Regulation (EU) 2015/35.

the Commission shall take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular in relation to small insurance undertakings.

Even though Commission Delegated Regulation (EU) 2015/35 sets out numerous provisions on proportionality, the call for evidence showed nevertheless that further work could be done to ensure that all requirements are proportionate to risks.

II. Removal of unintended technical inconsistencies

In order to ensure that the standard formula continues to meet the requirements set out in paragraphs 2 and 3 of Article 101 of Directive 2009/138/EC on an ongoing basis, recital 150 of the Commission Delegated Regulation (EU) 2015/35 envisages that the Commission will review the methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement with the standard formula, making use of the experience gained by insurance and reinsurance undertakings during the transitional period and the first years of application of these delegated acts, and be performed before December 2018.

The Call for Evidence confirmed that the review could address significant weaknesses experienced by stakeholders (e.g. non-life risk calibrations). It could also consider more consistency across sectorial rules to the extent possible, taking into account the unavoidable differences between the business models of the financial institutions. The review could help to maintain EU insurers at the cutting edge of financial services (e.g. consistency with CRR/CRD and EMIR, inclusion of new risk mitigation techniques) and to remove undesirable effects (reliance on ratings).

III. Removal of unjustified constraints to financing

Respondents to the call for evidence highlighted that the Solvency II framework may create unintended barriers to long-term investment. The Solvency II Delegated Regulation was already amended in 2015 to support investments in infrastructure projects and ELTIFs, and further recalibrations will be considered to facilitate insurers' investments in infrastructure corporates. The upcoming review provides an opportunity to consider additional initiatives in the context of the Capital Markets Union.

Going further on this area III means additional work to identify investments creating growth and jobs and offering sufficient transparency and credit quality to justify improved risk sensitiveness in the standard formula. Hence, this call for technical advice only covers items related to areas I and II. As regards area III, except for the above-mentioned items, the Commission is in the process of conducting an in-depth assessment of investment classes that merit further investigation, and may request EIOPA's technical support at a later stage where required, in line with Recital 150 which also refers to the market risk module.

1.2 Principles that EIOPA should take into account

In providing its technical advice, EIOPA is invited to take account of the following principles:

- It should respect the requirements of the EIOPA Regulation and is invited to widely consult market participants in an open and transparent manner. EIOPA should provide advice which takes account of different opinions expressed by the market participants during the consultation and should provide a feedback statement on the consultation justifying its choice vis-à-vis the main arguments raised during the consultation.

- The principle of proportionality: the technical advice should not go beyond what is necessary to achieve the objectives of the Solvency II Directive and provide for the proportionate application of the Solvency II Directive, in particular in relation to small insurance undertakings, and avoid creating excessive administrative or procedural burdens for (re)insurers.

- EIOPA will determine its own working methods depending on the content of the issues being dealt with. Nevertheless, horizontal questions should be dealt with in such a way as to ensure coherence between different standards of work being carried out.

- While preparing its advice, EIOPA should seek coherence within the regulatory framework of the Union, and in particular Directive 2009/138/EC.

- The provided technical advice should contain sufficient and detailed explanations for the assessment done, and be presented in easily understandable language respecting current legal terminology at European level.

- EIOPA should justify its advice by identifying, where relevant, a range of technical options and by undertaking evidence-based assessment of the costs and benefits of each. The results of this assessment should be submitted alongside the advice to the Commission. Where administrative burdens and compliance costs on the side of the industry could be significant, EIOPA should where possible quantify these costs.

- EIOPA should provide sufficient factual data backing the analyses gathered during its assessment. To meet the objectives of this mandate, it is important that the presentation of the advice produced by EIOPA makes maximum use of the data gathered and enables all stakeholders to understand the overall impact of the options presented by EIOPA.

- EIOPA should provide comprehensive technical analysis on the subject matters described below covered by the delegated powers of the Commission included in the relevant provision of the Solvency II Directive and its recitals.

- The technical advice given by EIOPA should not take the form of a legal text.

- EIOPA should address to the Commission any question it might have concerning the clarification of the text of the legislative act, which it should consider of relevance to the preparation of its technical advice.

2. Procedure

The Commission requests the technical advice of EIOPA in preparation of the review of the Solvency II Delegated Regulation which is expected to be carried out in 2018 regarding the questions referred to in section 3 of this formal mandate.

The Commission reserves the right to revise and/or supplement this formal mandate. The technical advice received on the basis of this mandate will not prejudge the Commission's final decision in any way.

In accordance with the established practice, the Commission may continue to consult experts appointed by the Member States to prepare amendments to the Solvency II Delegated Regulation.

The Commission has duly informed the European Parliament and the Council about the final version of this mandate. Should the Commission adopt delegated acts, it will notify them simultaneously to the European Parliament and the Council.

3. EIOPA is invited to provide technical advice on the following issues:

3.1. Proportionate and simplified application of the requirements

3.1.1. The simplified calculations provided for specific sub-modules and risk modules, as well as the criteria that insurance and reinsurance undertakings shall be required to fulfil in order to be entitled to use each of those simplifications (under the empowerment in Article 111(1)(l) of Directive 2009/138/EC).

The Delegated Act provides simplifications for many, but not for all, calculations in the standard formula. For example, no simplifications are provided for the non-life lapse risk submodule and the submodules of the non-life catastrophe risk.

EIOPA is asked to:

- Provide information on the current use of the existing simplifications and, where relevant, on reasons why these simplifications are not used.
- Suggest improvements for the existing simplifications and explore and propose methods and criteria for further simplifications, in order to ensure that simple and easy to apply methodologies are provided for all standard formula calculations, bearing in mind the need to strengthen a proportionate application of the requirements.

3.1.2. The methods and assumptions to be used when applying the look-through approach to calculate the market risk module, the underwriting risk module and the counterparty default risk module (under the empowerments in Article 111(1)(a) and 111(1)(c) of Directive 2009/138/EC).

EIOPA is asked to review the simplification provided for the look-through approach (Article 84(3) of Regulation (EU) 2015/35).

In particular, EIOPA is asked to:

- Provide information on investments by insurers through collective investment undertakings and other investments packaged as funds and on the amount of those investments which are hedging unit-linked and index-linked products, including information on cases where the simplified methodology (currently limited to 20% of the assets) does not cover the whole portfolio.
- Suggest refinements to this simplification to cover all investments for which a simplified methodology would allow proportionate and risk-based calculations of the solvency capital requirement. Such refinements should in particular take account of the objective to reduce the reliance on external ratings.

3.1.3. The methods, assumptions and standard parameters to be used when calculating the non-life catastrophe risk submodule and the counterparty default module (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

The counterparty default risk module and as the non-life catastrophe risk submodule require complex calculations.

EIOPA is asked to:

- Provide information on the relative significance of capital requirements related to these modules.
- Assess if this complexity is proportionate to the nature, scale and complexity of these risks, in particular for small and medium-sized undertakings.
- Where appropriate, develop suggestions for simpler structures for these modules, respecting their existing scope.

3.2. Removal of unintended technical inconsistencies

3.2.1. Methods, assumptions and standard parameters to be used when assessing the credit risk in calculating the spread risk submodule, the market risk concentration submodule and the counterparty default risk module with respect to references to external credit ratings (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

In line with the provisions of Regulation (EC) 1060/2009, the Union is working towards reviewing, at a first stage, whether any references to external credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on such external credit ratings and, at a second stage, all references to external credit ratings for regulatory purposes with a view to deleting them by 2020, provided that appropriate alternatives to credit risk assessment are identified and implemented.

The Solvency II standard formula provides for different risk considerations depending on whether an external rating is available or not and what rating is assigned to such exposure. To mitigate the risk of over-reliance on ratings, Solvency II provides that insurers, when they use an external credit rating assessment in the calculation of technical provisions and the Solvency Capital Requirement, shall assess the appropriateness of those external credit assessments as part of their risk management by using additional assessments wherever practicably possible in order to avoid any automatic dependence on external assessments. In addition, the Solvency II Delegated Regulation (Article 4(5)) sets out a requirement on (re)insurers to produce their own internal credit assessments for larger or more complex exposures, which also contributes to reducing the risk of over-reliance. Even though such mitigation rules are in place, the use of ratings contained in the Solvency II Delegated Act may create an incentive for (re)insurers to rely on assessments from rating agencies.

Therefore, EIOPA is asked to:

- Further develop the framework for the use of alternative credit assessments in the Solvency II standard formula, by setting out methods and criteria for a standardized approach to derive alternative credit assessments. Such an approach should also target exposures that do not have an external credit assessment, and not be limited to large and complex exposures.

3.2.2. Standard parameters to be used when calculating specific underwriting risk modules (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

EIOPA is asked to assess which standard parameters need to be changed amongst the following underwriting submodules and to suggest possible new calibrations where appropriate, making use of the experience gained and data gathered during the transitional period and the first year of application of Solvency II, also making use of relevant data provided by other parties:

- The standard parameters for non-life premium and reserve risk, and the standard parameters for medical expense risk, that should be calibrated on the basis of extended data; in this context, the definition of the volume measure for premium risk should be reassessed for continued appropriateness.
- The standard parameters for mortality and longevity risk in the life and health underwriting modules, which should be assessed for their continued appropriateness. EIOPA is also asked to investigate more granular approaches for longevity risk, with a view to a calibration differentiated by age groups. EIOPA is asked to assess the costs and benefits of these more granular approaches, in particular in view of their risk sensitivity and complexity.

3.2.3. The methods and assumptions to be used when calculating the non-life catastrophe risk sub module (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

In addition to the advice on a possible simpler structure (section 3.1.3. above), EIOPA is asked to assess the continued appropriateness of the methods and assumptions, and where required, the parameters, used when

calculating the non-life catastrophe risk submodule, in particular in view of the approach on contractual limits as set out in recital 54 of Delegated Regulation (EU) 2015/35.

3.2.4. Assumptions used when calculating the market risk concentration submodule (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

EIOPA is asked to report on assumptions currently made by insurance and reinsurance undertakings when calculating the market risk concentration submodule and their impact.

3.2.5. The methods, assumptions and standard parameters to be used when calculating the market risk module with respect to related undertakings (under the empowerment in Article 111(1)(c) of Directive 2009/138/EC).

The look-though approach is currently not applied to investments in related undertakings.

EIOPA is asked to:

- Provide information on related undertakings used by insurance and reinsurance undertakings as an investment vehicle.
- Assess under what conditions it may be appropriate to extend the look-through approach to such undertakings.

3.2.6. The differences between Delegated Regulation (EU) 2015/35 and Directive 2013/36/EU and Regulation (EU) No 575/2015 as regards exposures guaranteed by a third party and as regards exposures to regional governments and local authorities (under the empowerments in Article 111(1)(c), (e) and (f) of Directive 2009/138/EC).

The Solvency II standard formula counts guarantees issued by the European Central Bank, Member States' central government and central banks, multilateral development banks and specific international organisations, as risk-mitigation techniques, where specific conditions are met.

EIOPA is asked to:

- Provide information on the current amounts of exposures guaranteed by a third party and of exposures to regional governments and local authorities.
- Assess the differences between the banking framework and Delegated Regulation (EU) 2015/35, in the treatment of regional governments and local authorities and in the treatment of exposures guaranteed by a third party.
- For each of these differences, assess if they are justified by differences in the business model of the two sectors, by diverging elements in the determination of capital requirements, or on other grounds.
- Investigate under which conditions the risk mitigating effect of guarantees issues by other guarantors can be recognised in the Solvency II framework.

3.2.7. With respect to risk mitigation techniques, which have significantly developed in recent years, the methods and assumptions to be used to assess the changes in the risk profile of the undertaking concerned and to adjust the calculation of the Solvency Capital Requirement, and the qualitative criteria that the risk mitigation techniques must fulfil in order to ensure that the risk has been effectively transferred to a third party (under the empowerments in Article 111(1)(e) and (f) of Directive 2009/138/EC).

Solvency II is a risk-based framework, which in particular takes account of the effect of certain risk mitigation techniques.

EIOPA is asked to:

- Provide information on recent market developments as regards risk mitigation techniques, in particular embedded derivatives and longevity risk transfer.

- Assess if the framework for the recognition of risk mitigation techniques appropriately covers these recent market developments.
- Where necessary, suggest updates to this framework.

3.2.8. The method and parameters to be used when assessing the capital requirement for counterparty default risk in the case of exposures to qualifying central counterparties and to derivatives (under the empowerments in Article 111(c) and (fa) of Directive 2009/138/EC).

Article 111(1)(fa) of Directive 2009/138/EC lays down that the Commission shall adopt delegated acts providing for the method and parameters to be used when assessing the capital requirement for counterparty default risk in the case of exposures to qualifying central counterparties. In addition, Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) introduced clearing obligations, in order to reduce the counterparty risk related to derivatives. Delegated Regulation (EU) 2015/35 does not yet explicitly take into account clearing arrangements.

EIOPA is asked to

- Provide information on the amounts of exposures to qualifying central counterparties and of exposures to derivatives.
- Develop an approach for qualifying central counterparties in the framework of the counterparty default risk module. The parameterisation of the new approach should ensure consistency with the treatment of such exposures in the case of credit institutions and financial institutions.
- Suggest how the Solvency II framework could be updated in its approach to cleared derivatives to take account of the reduced counterparty risk.

3.2.9. The method to be used when calculating the adjustment for the loss absorbing capacity of deferred taxes (under the empowerment in Article 111(1)(i) of Directive 2009/138/EC).

The calculation for reduction in capital requirements due to a deferred tax adjustment is complex, and requires a high level of supervisory judgement, resulting in possibly divergent practices in member states.

EIOPA is asked to report on the different methods currently applied and on their impact.

3.2.10. The subset of standard parameters in the life, non-life and health underwriting risk modules that may be replaced by undertaking-specific parameters, and standardised methods to be used to calculate those parameters (under the empowerments in Article 111(1)(j) and (k) and in Article 234 of Directive 2009/138/EC).

The framework for undertaking specific parameters provides for standardised methods to replace a defined set of parameters in the standard formula, where sufficient data is available to calculate calibrations tailored to its liabilities. This framework should be provided wherever possible in the underwriting risk module.

EIOPA is asked to:

- Provide information on the use of undertaking specific parameters by insuranceand reinsurance undertakings and by groups.
- Assess standardised methods to replace additional parameters in the underwriting risk modules and assess any criteria with respect to the completeness, accuracy and appropriateness of the data used that must be met before supervisory approval is given.
- Assess alternative methods for the calculation of the undertaking specific parameter for non-proportionate reinsurance, with a view to amending or replacing the current method.
- Assess additional methods to calculate group specific parameters that build on undertaking specific parameters, in particular in view of their risk sensitivity and complexity.

3.2.11. The methods and assumptions to be used when calculating the risk margin, in particular the cost-of-capital rate (under the empowerment in Article 86(1)(d) of Directive 2009/138/EC).

According to Article 77(5), the risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof.

EIOPA is asked to:

- Provide information on the relative size of the risk margin in insurers' balance sheet.
- Assess if the methods and assumptions applied in the calculation of the risk margin continue to be appropriate, in view of a changed market environment. In particular, EIOPA is asked to review the cost-of-capital rate.

3.2.12. Where inconsistencies with Directive 2013/36/EU and Regulation (EU) No 575/2013 exist, the features determining the classification of own funds items (under the empowerment in Article 97 of Directive 2009/138/EC).

Certain own funds items are shared by the insurance and banking frameworks (e.g. certain debt instruments). However, feedback received through the Call for Evidence highlighted that certain features (e.g. contractual clauses) do not receive the same treatment in both frameworks.

EIOPA is asked to:

- For those eligible items which are comparable between the banking framework and Delegated Regulation (EU) 2015/35, assess differences in their classification.
- For each of these differences, assess if they are justified by differences in the business model of the two sectors, by diverging elements in the determination of own funds requirements, or on other grounds.

3.2.13. The list of own-fund items, deemed to fulfil the tier 1 eligibility criteria, which contains for each own-fund item a precise description of the features which determine its classification (under the empowerments in Articles 97(1) and 99(a) of Directive 2009/138/EC).

The list of own funds items deemed to fulfil the tier 1 eligibility criteria contains paid-in subordinated mutual member accounts, paid-in preference shares and the related share premium account, and paid-in subordinated liabilities. These items are subject to a quantitative limit of 20%.

EIOPA is asked to assess whether, if this quantitative limit were removed, the detailed eligibility criteria applicable to these items would need to be modified, in order to ensure that the criteria set out in Article 94(1) continue to be fulfilled.

3.2.14. The application of the accounting consolidation based method to calculate the Solvency Capital Requirement under the standard formula with respect to the calculation of currency risk (under the empowerment in Article 234 of Directive 2009/138/EC).

The calculation of currency risk within the standard formula may penalize holding own funds to cover a related undertaking's Solvency Capital requirement in the currency in which this undertaking's assets and obligations are denominated.

EIOPA is therefore asked to:

- Provide information on currencies chosen by insurance groups to hold their own funds.
- Investigate if the approach taken to group currency risk adequately covers the risk to which the group is exposed, taking into account the incentives given to the group's risk management, and suggest modifications where appropriate.