

# Consultation paper on the Statement on supervisory practices and expectations in case of breach of the Solvency Capital Requirement

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## INTRODUCTION

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1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Supervisory Statement on the basis of Article 29(2) of Regulation (EU) No 1094/2010 to promote common supervisory approaches and practices.

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We welcome this initiative to increase supervisory convergence but acknowledge the limits of convergence given the necessary flexibility and local regulation applicable in case of recovery situation.

Divergent practices are indeed observed across Member States in case of low S2 ratio before any SCR breach where the potential high SCR sensitivity triggers different actions from NCAs (e.g. specific thresholds, link with risk appetite, stress testing). In some countries, local regulation requests a P&L projection under local GAAP as part of the recovery plan.

The concept of necessary flexible supervisory ladder should be further defined to reach some good balance between agility and supervisory convergence.

We also note that some supervisors encourage undertakings making early brainstorming (outside any period of crisis) on recovery and resolution as part of a preemptive action plan.

An efficient risk management and appropriate ORSA can help to identify risky situation early.

2. This Supervisory Statement is based on Directive 2009/138/EC (Solvency II) and addressed to the competent authorities, as defined in point (i) of Article 4(2) of Regulation (EU) No 1094/2010.

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3. The supervisory practices addressing the supervisory ladder are necessarily flexible and should consider the specific situation of the insurance or reinsurance undertaking. However, it is important that when certain triggers are reached, such as non-compliance with the Solvency Capital Requirement (SCR), a minimum convergent approach is applied in order to avoid supervisory arbitrage.

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4. This has always been an area of extreme importance. However, during the last 4 years (2016-2019) only few breaches of the SCR have happened. There were 12 undertakings which have had a breach of the SCR for a period of two consecutive years, which represents less than 0,5% of all undertakings subject of SII. The breaches are spread between 6 Member states.

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5. Since the Covid-19 pandemic has emerged at the beginning of 2020, the world is facing this new risk and more frequent breaches of the SCR could be observed in the future. European undertakings have demonstrated resilience to the impact of the Covid-19 pandemic until now, however, the current environment amplifies the risks of non-compliance.

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6. The ongoing uncertainty can lead to breaches of SCR in the future, in which case the Solvency II supervisory ladder of intervention allows supervisory authorities to take early actions including among others the approval of a recovery plan.

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7. In this environment and considering a potential increase of non-compliance cases it is of particular importance to ensure consistency in the way the recovery plans are developed, assessed and approved.

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8. The aim of this Supervisory Statement is to promote supervisory convergence in the application of the supervisory ladder, in particular addressing the recovery plan required in case of breach of the SCR. This Supervisory Statement is developed to be applicable at any time. However, one specific paragraph is included addressing supervisory expectations on recovery plans to be developed in the context of the Covid-19 pandemic.

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In case of non-compliance with the SCR, supervisors should differentiate between a situation where only a particular undertaking is concerned and an exceptional adverse situation as referred to in art. 138 §4 of the Solvency II Directive.

The declaration of such an exceptional adverse situation, and the possible extension of the recovery period up to 7 years, have a major impact on the recovery plan and the recovery measures to be foreseen.

Supervisory authorities should consider the circumstances that have led to the “exceptional adverse situation”. This could be

- (a) a fall in financial markets which is unforeseen, sharp and steep
- (b) a persistent low interest rate environment;
- (c) a high-impact catastrophic event.

It is therefore advised that national supervisory authorities (together with EIOPA) consider the possible declaration of exceptional adverse situations in an early stage when non-compliance with the SCR is observed, in order to avert the insurance undertaking from taking potentially disproportionate and/or pro-cyclical recovery measures.

In other situations recovery plans should focus on the removal of circumstances that have caused the breach of the SCR.

Possible requirements should not come into conflict with specific treatment as laid down in Art. 308c for users of the transitional measures.

## OBSERVATION OF NON-COMPLIANCE

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9. Insurance and reinsurance undertakings should consider as the date of non-compliance with the SCR the date on which non-compliance with the SCR has been observed through their on-going monitoring. Accordingly, supervisory authorities should consider as the start of the two-months period - prescribed for the submission of the recovery plan - the date of observation of a breach of the SCR as indicated by the undertaking in its notification to the supervisory authority, regardless of quarterly/annual reporting.

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It would be good to clarify whether the concept of SCR breach is below 100% coverage ratio including or excluding specific adjustments.

The coverage ratio is expected to be the one regularly reported including adjustments as approved by the supervisor (e.g. VA, other LTG measures, USP, (Partial) Internal Model...)

10. In case an undertaking did not detect and hence did not inform the supervisory authority about the breach of the SCR and this non-compliance is first established by the supervisory authority (e.g. during an on-site inspection), the date of observation of a breach and therefore starting date for submitting a realistic recovery plan should be the date indicated by the supervisory authority in its notification to the concerned undertaking [1].

[1] If an undertaking fails to detect a breach of the SCR, this issue should be assessed and followed by the supervisory authority, in particular from a governance perspective.

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Clarification is needed concerning the goal of the recovery plan.

From our understanding approved LTG – measures should be taken into account in the recovery plan and should not be questioned for this purpose.

It should also be clarified whether some downwards adjustment should apply in order to reflect the stressed situation (e.g. illiquid assets, participations following a derisking strategy).

This would require a case by case approach based on general guidelines.

If a breach were not detected by the undertaking, the effectivity of risk management and the quality of ORSA could be questioned. Both together should avoid such an incident.

## REQUEST OF A RECOVERY PLAN

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11. Insurance and reinsurance undertakings are required to submit to the supervisory authorities a realistic recovery plan within two months upon the observation of a breach of the SCR.

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12. If the undertaking adopted prompt recovery measures which restored compliance with the SCR within two months and these measures are considered by the supervisory authority as adequate to preserve a sustainable solvency situation, including an assessment of a forward-looking perspective of the solvency position, the supervisory authority may consider that the submission of recovery plan is not needed. The undertaking should at least engage in a supervisory dialogue and submit to the supervisory authority, within the same period of two months, relevant and adequate information to allow a proper assessment of the

causes for the non-compliance, the solvency situation, including on the assumptions, scenarios and measures supporting the sustainability of the restored solvency position. Based on this information, the supervisory authority should assess if additional information, measures or a recovery plan are needed.

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## CAUSES OF NON-COMPLIANCE

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13. Supervisory authorities should request from insurance and reinsurance undertakings, as part of the recovery plan, an analysis of the causes of non-compliance and of any shortcomings in their risk management system, including possible inadequacy of:

- a) internal risk appetite;
- b) quantitative or qualitative indicators/measures;
- c) overall risk tolerance limits;
- d) metrics used within the risk management system to measure risks;
- e) stress test framework;
- f) monitoring process.

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Additional causes could include: management actions, emerging risks, Intra Group Transactions, spill-over or systemic effects...

14. If the causes of the breach of the SCR have impact also on business operations of the undertaking, in particular with regard to critical processes and functions (such as policy administration, claims handling, investment management, reinsurance arrangements or information technology services), the undertaking should indicate, as part of the recovery plan, how it intends to ensure the appropriate day-to-day operation, including governance aspects.

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The term "release of technical provisions" is unclear in the context of Solvency II, more explanation on this would be welcome.

## ASSUMPTIONS AND SCENARIOS OF THE RECOVERY PLAN

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15. Insurance and reinsurance undertakings should take at least the following into account when preparing their recovery plan in accordance with Article 142 of Solvency II, considering the proportionality principle, the level of non-compliance with the SCR and the possible duration of the deterioration of the undertaking's financial conditions:

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- a) the forecast balance sheet and estimates should be based on realistic assumptions both in relation to the economic scenarios and business of the undertaking, supported by justifications;

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Default and counterparty risk should also be assessed

b) the assumptions should be tested for the different business lines, involving the key functions, and where applicable and appropriate the parent company, subsidiaries and branches;

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It is our understanding that only the relevant key functions should be involved, depending on the reasons for the SCR breach, and not necessarily all four key functions. This should be clarified.

c) the scenarios should consider any foreseeable and probable relevant adverse events that can occur in the forecasted period considering undertaking's business model and strategy;

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From our point of view it makes sense to analyse sensitivities for the most relevant assumptions, especially when there is high uncertainty regarding these assumptions. To demand to consider further adverse events other than those that have led to the SCR breach seems to overburden companies with a SCR breach in comparison to those who are close to the SCR breach. Further adverse scenarios should be analysed in the ORSA by all undertakings and not in the recovery plan for those undertakings with a SCR breach.

Other assessments could include: reinsurance evolution, liquidity, Business Continuity and operational risk, State intervention,...

d) the forecast balance sheet and estimates should reflect a recalculation of the future cash-flows considering the economic scenarios defined;

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e) the forecast balance sheet and estimates should reflect an assessment of the business exposures related to the risk coverages or guarantees of the insurance products and explain how that assessment was reflected in the valuation of liabilities; this should include the assessment of probable adverse events and policyholder behaviour including lapses, cancellations, increasing claims and potential litigation over compensation disputes, depending on the risk exposures if justified by the economic environment;

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f) in case the forecast balance sheet and estimates reflect the implementation of management actions leading to investment gains, reduction of expenses/commissions or release of technical provisions, those actions should be consistent with the business strategy and with any re-calculation of the technical provisions, loss absorbing capacity of deferred taxes or loss absorbing capacity of technical provisions;

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g) following the assessments referred to in the previous points, the expected future profits should be reassessed based on a revised plan for the next business period(s).

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The intention of this guideline is unclear to us. A clarification would be appreciated.

16. When preparing recovery plans in the context of the Covid-19 pandemic, undertakings should take the following specific points into account in addition to Point 15:

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It seems arbitrary to formulate specific requirements w.r.t. the Covid-19 pandemic in a principle based regime. Hence we deem it inappropriate to add specific points to the guidance from guideline 15. Hence this guideline is either obsolete or if EIOPA requires specific guidance in addition to guideline 15 we believe the guidelines should adhere to all kind of crises and not particularly refer to Covid-19. The scenarios should sufficiently reflect uncertainty.

a) realistic assumptions both in relation to the economic scenarios and business of the undertaking are expected to reflect a possible economic downturn and its impact on the undertaking's business models including premiums estimates, to consider (i) volatility of the financial markets, (ii) changes in yield curves, (iii) probable mass downgrades of credit ratings and (iv) possible positive correlation of some asset classes under the current environment;

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cf. our response to 15c. All of the points mentioned in 16a may or may not actually occur. If the regulator intends for undertakings with an SCR breach during the Covid-19 pandemic to mitigate the possible consequences of the points mentioned above these companies are faced with a major regulatory discrimination compared to companies that have not reported an SCR breach but might face one of the points above occurred. We emphasise that one should not refer to Covid-19 in this context. The ORSA scenarios and assumptions should be deemed sufficient (and will include Covid-19 if relevant at that point in time).

b) the economic scenarios should consider how the Covid-19 pandemic might evolve including possible further waves;

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If EIOPA specifies to take into account the effects of possible further waves (another requirement specifically for undertakings with a SCR breach) it should also be clarified what these further waves are supposed to entail. This should then concern all undertakings and not only those with a recent SCR breach. Moreover, as commented above, such aspects should be considered in the context of ORSA and not in a recovery plan. In addition, it is unclear to what extent "further waves" are required to be considered. Yet, it is not foreseeable how extreme the pandemic will evolve over time and the cone of uncertainty is wide.

c) the forecast balance sheet and estimates should reflect an assessment of the business exposures related to the risk coverages or guarantees of the insurance products, including possible new products launched and/or products stopped being commercialised or substantially changed in light of the Covid-19 pandemic, and explain how that assessment was reflected in the valuation of liabilities. This should include the assessment of possible decrements and policyholder behaviour including lapses, cancellations, increasing claims and potential litigation over compensation disputes, depending on the risk exposures.

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17. Supervisory authorities should assess the reliability of the assumptions and methods based on the rationale provided by the undertakings and considering the marketability of assets under the different scenarios, plausibility of valuations, risk concentrations and the undertakings' business model.

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18. Concerning projections for cross-border underwriting activities, supervisory authorities should exchange information to capture local specificities, in particular to assess the reliability of the economic scenarios for the cross-border business and enhance a common understanding of the economic scenarios being considered and of the solvency position of the undertaking.

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19. Supervisory authorities should make use of European cooperation forums, where appropriate, such as colleges of supervisors and cooperation platforms to foster convergence of approaches across Member States.

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## RECOVERY MEASURES

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20. Insurance and reinsurance undertakings should detail the realistic and timely recovery measures to restore their solvency position and sustain it in a medium to long-term period, also considering the internal risk of tolerance limits established in the undertakings' risk appetite framework. Changes and improvements for the risk management system to address possible shortcomings as referred in Point 13 should be detailed.

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21. The recovery plan should document the feasibility of the recovery measures, including foreseeable and probable relevant adverse events and explain:

- a) the impact on the undertaking's solvency and liquidity;
- b) the timeline for implementation and the expected time needed to observe the benefit of the measure;
- c) where applicable, past experience, interconnectedness' implications, changes to the business model and to the risk profile.

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Regarding the impact of the recovery measures on the undertaking's solvency, liquidity and risk profile, the overall effect of all measures should be sufficient. Breaking down the effect of each measure should not be required. As far as the effect on the risk profile is concerned, a qualitative description may also be sufficient.

22. Undertakings should include in the recovery plan a comprehensive implementation plan, breaking it down into specific actions and timelines for each step with a feasibility assessment having in mind the potential situation of the market, the extent to which implementation depends on third parties, risks, mitigation measures and where relevant alternatives.

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23. Supervisory authorities should assess if there is sufficient evidence that the proposed recovery measures can be implemented in a timely and effective manner in the current environment and over the recovery period. Recovery measures without a properly described and justified impact and feasibility assessment should not be considered reliable.

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24. Supervisory authorities should further consider contagion effects, including cross-sectoral and possible procyclical effects.

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An extension of the recovery period up to 7 years may also be considered, as put forward in art. 138 §4 of the Solvency II Directive. As a possible extension of the recovery period has a major impact on the recovery plan, supervisory authorities should provide clarity early on whether an exceptional adverse situation will be declared and whether an extension may be granted.

This extension of the recovery period is especially relevant in order to prevent pro-cyclical actions from insurance undertakings or supervisory authorities.

## RECOVERY PERIOD

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25. Insurance and reinsurance undertakings can foresee in the recovery plan a period longer than six and up to nine months to restore compliance, explaining the reason why six months would not be enough.

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This paragraph should also consider a possible extension of the recovery period up to 7 years.

26. When a period longer than six months (up to nine months) is requested by the undertaking in the recovery plan, the supervisory authority should, as a first step, review the recovery plan<sup>[2]</sup>, evaluate the recovery measures, assess the reasons for the additional time requested, assess if the time proposed is consistent with the implementation of such measures and if the market conditions allow for such implementation.

[2] If the extension of the recovery period is requested before the recovery plan is formally submitted, then at least the main points of the plan need to be communicated to the supervisory authority.

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Additional considerations by the supervisory authority may be:

- The severity of the shocks to which the insurance undertaking is exposed: a more severe shock likely requires a (longer) extension of the recovery period. In particular, the existence of “exceptional adverse situations” should be an important consideration by the supervisory authority when assessing the request of an extension of the recovery period.
- The potential pro-cyclical effects of not extending the recovery period

27. In case the extension is requested towards the end of the sixth months of the recovery period, the supervisory authority should consider whether sufficient progress or positive outlook is observed during the initial recovery period, whether the extension is in the best interests of policyholders and whether there is not a significant risk for the breach of the Minimum Capital Requirement.

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## MONITORING AND NON-COMPLIANCE AT THE END OF THE RECOVERY PERIOD

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28. After a recovery plan has been submitted, insurance and reinsurance undertakings should notify supervisory authorities of any significant change in the extent of the solvency or liquidity shortfall.

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Additional considerations for supervisors when imposing additional measures should be:

- (i) potential pro-cyclical effects of the supervisory measures
- (ii) the severity of the shock to which the insurance undertaking is exposed
- (iii) the possible aggravation of the shock (during the recovery period) to which the insurance undertaking is exposed.

29. If compliance with the SCR is not restored within the prescribed recovery period, the supervisory authorities should impose additional measures. These measures may vary depending on the specific situation and national laws and should be proportionate, taking into account in particular (i) the level of non-compliance with the SCR, (ii) the duration of the deterioration of the undertaking’s financial conditions and (iii) the sustainability of the applied measures by the undertaking to restore its solvency for a medium to long time horizon. These measure should always consider the interests of policyholders, which may justify restrictions to writing new business and/ or constraints to the free disposal of assets. Depending on supervisory powers under national laws, supervisory authorities should also consider subjecting certain operations to prior supervisory approval or impose specific governance changes or transactions.

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30. If the non-compliance situation has not improved or if at any time the supervisory authority concludes that the measures in place will not allow the recoverability of the solvency position in a sustainable manner and that the interests of the policyholders are not properly safeguarded, the supervisory authority should consider to withdraw the undertaking's authorisation in accordance with the conditions of Article 144 of Solvency II.

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## QUESTIONS TO SUPPORT THE IMPACT ASSESSMENT

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In preparing the Statement on Supervisory practices and expectations in case of breach of the Solvency Capital Requirement, EIOPA took into consideration the general objectives of the Solvency II Directive, namely:

- adequate protection of policyholders and beneficiaries, being the main objective of supervision;
- financial stability; and
- proper functioning of the internal market.

The drafting of the Statement is also guided by EIOPA's statutory objectives, as reflected in the Regulation of the Authority, notably:

- improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision,
- ensuring the integrity, transparency, efficiency and orderly functioning of financial markets,
- preventing regulatory arbitrage and promoting equal conditions of competition,
- ensuring the taking of risks related to insurance, reinsurance and occupational pensions activities is appropriately regulated and supervised, and
- enhancing customer protection.

To analyse the impact of the proposed supervisory convergence measures, the final impact assessment to be developed ex-post this public consultation foresees that a baseline scenario is applied as the basis for comparing supervisory convergence options. This will help to identify the incremental impact of each action considered in this supervisory statement. The aim of the baseline scenario is to explain how the current situation would evolve without additional intervention creating level playing field in the application of the supervisory ladder, in particular addressing the recovery plan required in case of breach of the SCR. The answers of the four last questions in the survey will be taken into account when assessing the impact of the suggested convergence practices.

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We welcome the impact assessment to get insight into possible areas of convergence and the other areas where flexibility and local regulations would hamper this convergence.

Consideration for a possible extension of the recovery period up to 7 years should also be part of the assessment.

3.1 Insurance and reinsurance undertakings should consider as the date of non-compliance with the SCR the date on which non-compliance with the SCR has been observed through their on-going monitoring and

they are required to submit to the supervisory authorities a realistic recovery plan within two months upon the observation of a breach of the SCR. In case non-compliance being first detected by the supervisory authority, the date of observation of a breach and therefore starting date for submitting a realistic recovery plan should be the date indicated by the supervisory authority in its notification to the concerned undertaking. **Is the suggested approach in relation to the observation of non-compliance expected to achieve more convergence in terms of undertaking's internal functioning, interaction with the NCAs and level playing field a national and European level?**

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Yes.

The proposed approach appears reasonable; the establishment of clearer guidelines in relation to the date of recognition of non-compliance should help achieve more convergence across NCAs. However, we note that there is some ambiguity in the case that non-compliance is first detected by the supervisory authority and that different interpretations of this may diminish the extent of supervisory convergence. Can you clarify whether this date refers to the date on which the supervisory authority makes the discovery of non-compliance, or if this applies retrospectively to the valuation date at which the supervisory authority deems that non-compliance first occurred?

We are also seeking clarification on the determination of "the date on which non-compliance with the SCR has been observed through their on-going monitoring". Specifically, we believe this should be considered as the date on which the non-compliance has been notified to the Board.

3.2 If the undertaking adopted prompt recovery measures which restored compliance with the SCR within two months in a sustainable matter considering as well the forward-looking perspective, the supervisory authority may consider that the submission of recovery plan is not needed. The undertaking should at least engage in a supervisory dialogue and submit to the supervisory authority, within the same period of two months, relevant and adequate information to allow a proper assessment of the causes for the non-compliance, the solvency situation, including on the assumptions, scenarios and measures supporting the sustainability of the restored solvency position. **Is the suggested convergence approach expected to limit the burden of preparing a recovery plan when considered as not needed by the NCA and to support the dialogue with the supervisor to agree on a plan for preserving stable restored solvency position and support the level playing field a national and European level?**

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The proposed approach would limit the burden on insurers in these circumstances if the supervisory authority exercises this discretion in not requiring the submission of a recovery plan. However, different supervisory authorities may apply different criteria to determine when it is appropriate to allow a derogation from submitting a recovery plan in a given set of circumstances. Introducing this level of discretion may lead to divergent practices across NCAs in this regard.

3.3 In the course of preparing recovery plan in accordance to Art. 142 of the Solvency II Directive undertakings should take into account additional specific points in the context of the Covid-19 pandemic, such as: (i) reflecting a possible economic downturn and its impact on the undertaking's business models in the economic scenarios and the business plans; (ii) considering involvement of the Covid-19 pandemic; (iii) reflecting on possible new products launched and/or products stopped being commercialised or substantially changed in light of the Covid-19 pandemic in the valuation of liabilities. **Is the suggested**

**convergence approach in the course of preparation of the recovery plan in the context of Covid-19 expected to help undertakings to better incorporate the expected impact of Covid-19 while assessing the forward looking solvency position?**

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While the proposed additional points make sense, we believe a principle based regime should not entail distinct questions regarding specific events (cf. our comments regarding 16.) This should be dealt on a case-by-case basis in a crisis-by-crisis context.

**3.4 Insurance and reinsurance undertakings can foresee in the recovery plan a period longer than six and up to nine months to restore compliance, explaining the reason why six months would not be enough. Is the suggested approach in relation to the extension of the recovery period (when requested at its beginning and towards its end) expected to bring more convergence in terms of undertaking's effective continuous work on recovering the solvency position, the interaction with the NCAs and level playing field a national and European level?**

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The suggested approach lacks clarity as the extension of the recovery period to 7 years is not mentioned. This appears harmful in terms of convergence, interaction with NCAs and level playing field.

Similar to the response to 3.2; this proposal introduces an additional level of discretion and may lead to NCAs applying different sets of criteria which may vary in onerousness in this regard.

**3.5 Is there any other area regarding the supervisory practices and expectations in case of breach of the Solvency Capital Requirement where you believe further supervisory convergence is needed?**

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No

## Contact

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