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From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	10 October 2014
To:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
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Subject:	COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT Accompanying the document COMMISSION DELEGATED REGULATION 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)

Delegations will find attached document SWD(2014) 308 final.

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Brussels, 10.10.2014
SWD(2014) 308 final

COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

COMMISSION DELEGATED REGULATION

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)

{C(2014) 7230 final}
{SWD(2014) 309 final}

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1. INTRODUCTION

This impact assessment covers the Delegated Regulation supplementing the Solvency II Directive[1], which is intended to specify a range of aspects of that Directive in view of its consistent implementation throughout the Union.

Solvency II is a framework for the regulation and supervision of insurance and reinsurance undertakings in the EU, adopted in 2009, modified in 2014 by a Directive known as "Omnibus II", and due to be applied on 1 January 2016. It replaces and improves 14 existing insurance Directives, and introduces economic risk-based solvency requirements across all EU Member States for the first time.

The proposed Delegated Regulation is based on a total of 76 empowerments in the Directive (listed in detail in Annex 2 of the impact assessment report). Issues for Delegated Acts are mainly connected to the technical operationalisation of the Directive. The impact assessment was carried out for those measures for which significant impacts are to be expected and those where the Solvency II Directive allows the Commission a genuine choice of options. The impact assessment concentrates on 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.

2. STUDIES AND CONSULTATIONS

Between 2005 and 2013, the development of Solvency II involved six Quantitative Impact Studies carried out by the European Insurance and Occupational Pensions Authority (EIOPA). Of these, the fourth fifth in particular aimed to inform policy choices in relation to the detailed rules to be set down in the Delegated Regulation. The Delegated Regulation is also based on more than 4000 pages of technical advice provided by EIOPA.

In addition, in parallel to the insurance and reinsurance industry contribution to the Commission Green Paper on the long-term financing of the European economy[2] in spring 2013, EIOPA −mandated by the Commission− prepared another technical report on the calibration and design of capital requirements for long-term investments[3], which was itself subject to public consultation and was eventually published in December 2013.

Since October 2009, the Commission held more than 20 meetings of an Expert Group of Member States on the draft Delegated Regulation; which led to a broad consensus on the text. The European Parliament was also present in Expert Group meetings. Drafts have also been shared with consumer groups and stakeholder organisations representing the views of the European insurance industry.

[1] Directive 2009/138/EC of the Council and the European Parliament, as amended by Directive 2014/51/EU, known as the Omnibus II Directive.

[2] COM(2013)150, 25 March 2013

[3] 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

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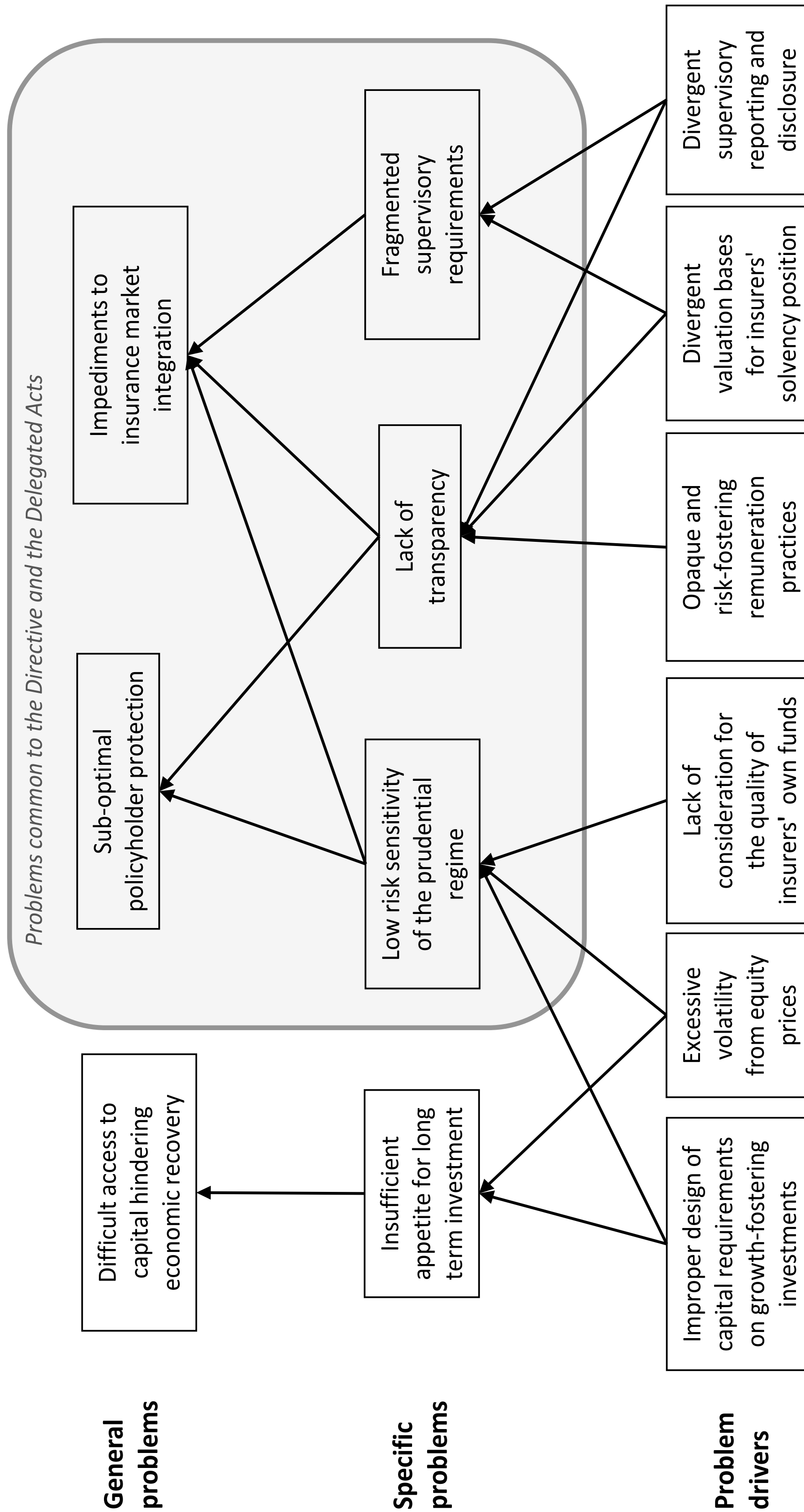
3. PROBLEM DEFINITION

Problem tree



Compared to the problems identified in the impact assessment for the Solvency II Directive, one of the four specific problems identified is new. The first three are: low risk sensitivity of the pre-existing prudential regime (not accurately reflecting the true financial state of insurers and reinsurers); lack of transparency (more precisely, lack of harmonisation of Member States' transparency rules and supervisory practices); and fragmented supervisory requirements. The new specific problem, arising out of the financial crisis, is insufficient appetite for long-term investments among insurers.

Three general problems arise out of the specific problems, of which the third corresponds to the fourth problem: sub-optimal policyholder protection; impediments to insurance market integration; and difficulty of access to capital hindering economic recovery.

Six problem drivers cause these problems:

1. **Improper design of capital requirements on growth-fostering investments**. Two regulatory obstacles to long-term investment by insurers were removed in the Solvency II Directive: limits on eligible investments, and artificial volatility in the prudential balance sheet. A third obstacle, the design and relative calibration of capital requirements, remains to be addressed in the Delegated Acts.

2. **Excessive volatility stemming from equity prices.** The Solvency II Directive includes an "equity dampener", which leads to countercyclical capital charges in respect of equity, and thus reduces the financial volatility associated with equities and reduces the likelihood of forced sales. However the time period over which the level of the market should be assessed is left to the Delegated Acts.

3. **Lack of consideration for the quality of insurers' own funds.** The Solvency II Directive classifies the capital resources of an insurer (its 'own funds') into three tiers depending on their quality. It sets out minimum limits for the amount of "tier 1 capital", to be included in the Solvency Capital Requirement and Minimum Capital Requirement and includes an empowerment for Delegated Acts in which stricter limits should be set out.

4. **Opaque and risk-fostering remuneration practices.** The issue of remuneration and how it can induce excessive risk taking has been identified and documented by the Commission during the last financial crisis.

5. **Divergent valuation basis for insurers' solvency positions.** Solvency II requires market-consistent valuation of all balance sheet items, but it is left to the Delegated Acts to determine which accounting principles may be used for valuation purposes.

6. **Divergent supervisory reporting and disclosure.** Solvency II will bring significant changes to the existing reporting and disclosure requirements. The Delegated Acts must provide further details as regards the nature and frequency of the information to be provided supervisors.

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4. OBJECTIVES

Objectives tree

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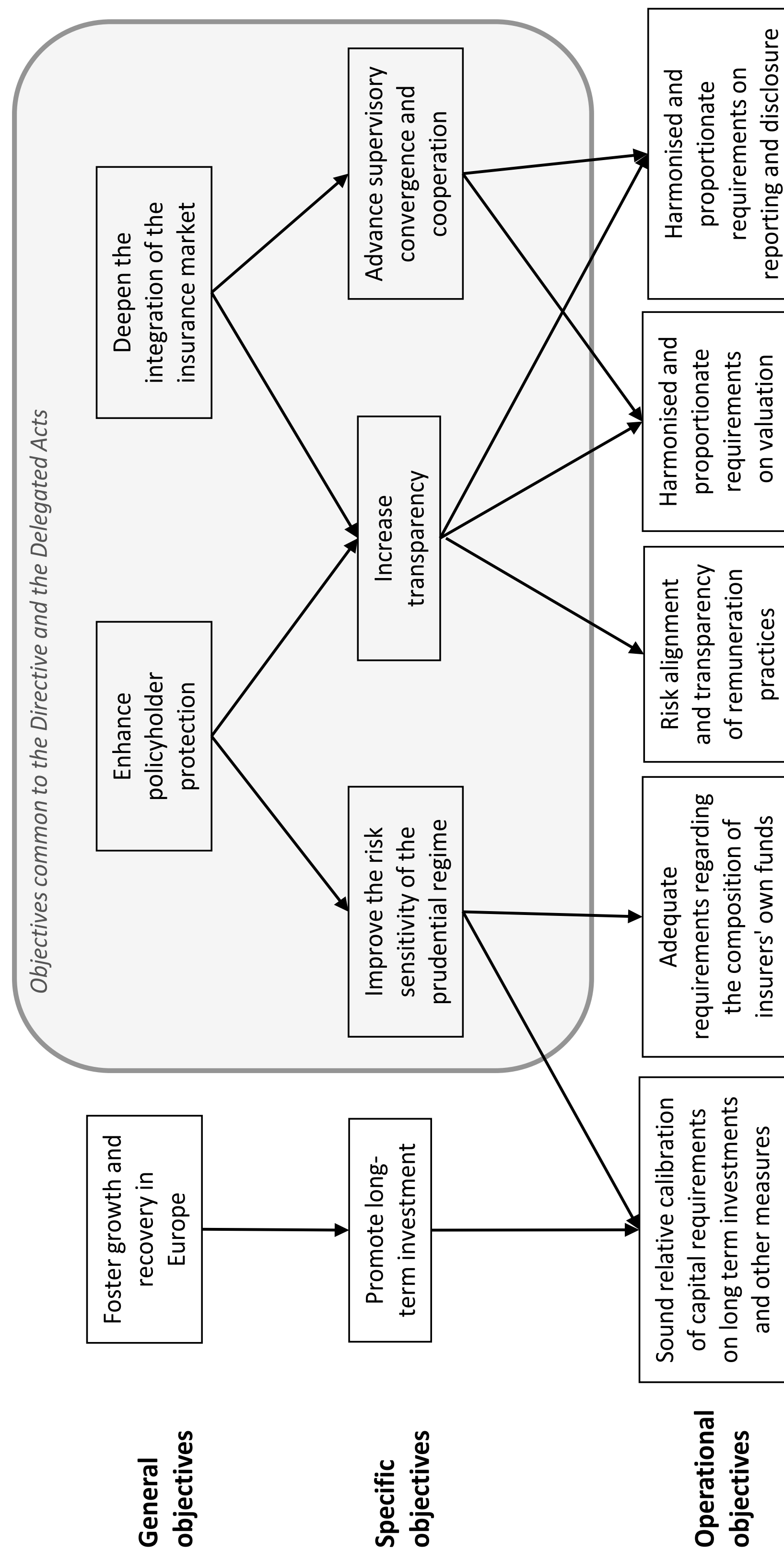

Of the three general objectives identified, one is new. The first two are: to enhance policyholder protection and to deepen the integration of the EU insurance market. The new general objective is to foster growth and recovery in Europe

Likewise, of the four specific objectives identified, one is new. The first three are: to improve the risk sensitivity of the prudential regime; to increase transparency, and to advance supervisory convergence and cooperation. The new specific objective is the promotion of long-term investments; it must be seen in the context of the Commission's Green Paper of spring 2013 on the long-term financing of the European economy, and follow-up Communication of 27 March 2014[4].

Five operational objectives arise out of these objectives:

1. **Sound relative calibration of capital requirements on long term investment and other measures**. The objective is to facilitate 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.

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

3. **Risk alignment and transparency of remuneration practices.** Legislative measures regarding remuneration have been adopted in the banking sector and investment sector. In June 2010, the Commission Green paper on corporate governance in financial institutions and remuneration policies called for similar legislative action in the insurance sector[5]. The Delegated Acts on the system of governance are the right instrument to implement this.

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. In the Delegated Acts, it must be decided to what extent this high-level principle should be translated into concrete accounting rules without imposing unnecessary additional costs on undertakings and supervisors.

5. ***Harmonised and proportionate reporting and disclosure requirements****. The Delegated Acts seek to harmonise reporting for supervisory purposes, to avoiding the burden of multiple and divergent requests in different Member States. It is important that supervisors receive substantial information with sufficient frequency,*

[4] COM 2014/168 final adopted on 27 March 2013.
[5] See section 5.7 of the Green paper.

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to allow timely intervention where appropriate,, while ensuring that reporting requirements are not too burdensome for smaller undertakings.

5. SUBSIDIARITY AND PROPORTIONALITY

The issue of subsidiarity was covered in the impact assessment for the Directive. It was decided then that maximum harmonisation would be required. 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 Commission.

The issue of proportionality is discussed in each of the policy options below.

6. POLICY OPTIONS

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

It is the *relative* calibration matters to enhance risk-sensitivity and create the desired investment incentives, Therefore, designing the standard formula first requires the creation of “buckets”[6] for different asset classes (e.g. equities, bonds, etc.) so that in a second step, risk factors for each bucket can be calibrated on market data. The preferred option is the most far-reaching and granular of the four options considered 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.

As far as equity is concerned, the preferred options is to differentiate between equities listed on regulated OECD markets on the one hand and other equities, including unlisted equities, and catching alternative investments (hedge funds, commodities, etc.). The corresponding stress scenarios would be a 39% or 49% fall in equity prices respectively, before application of the countercyclical equity risk dampener (see section 5.2). In addition, equities within certain types of funds recently created by EU legislation (European Social Entrepreneurship Funds and European Venture Capital Funds)[7] would attract the lower charge applicable to listed equities, even if these equities are unlisted. The same would apply to equities held in closed-ended, unleveraged alternative investment funds, in order to stimulate private equity/venture capital investments.

As far as private debt is concerned, the main distinction is between corporate bonds and loans (including a tailored treatment for high-quality covered bonds) on the one hand, and securitisations on the other hand. The preferred option includes provisions in favour of unrated bonds and loans, to avoid overreliance on ratings and punitive treatment of unrated investments (use of issuer or issuing programme ratings, recognition of risk-mitigation due to collateral or guarantees by the European Investment Bank or the European Investment Fund). Lastly, investments in infrastructure project bonds would be treated as corporate bonds, even where credit risk is tranched, instead of being treated as securitisation.

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

[7] If the negotiations on a proposal for a regulation creating European Long-Term Investment Funds had been concluded at the time of adoption of the Delegated Regulation, such funds could have benefitted from the same favourable treatment as EVCF and ESEF.

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As far as securitisation is concerned, the latest EIOPA technical advice, from December 2013[8] is taken into account. It includes a differentiated treatment for high-quality securitisation positions, on the basis of criteria pertaining to structural features, the nature of underlying exposures and their underwriting process, and transparency for investors. Under the preferred option, the risk factors would be even more favourable than recommended by EIOPA, which used available securitisation spread history covering 2007-2013, ie. mostly crisis years. In the preferred option, reliance on data from crisis years is reduced and 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 directly[9].

The preferred option would provide for highly-tailored capital requirements for insurers' investments, allowing for statistically and economically justified lower capital requirements if they pick long-term, high quality assets. However, it is slightly more complex to implement, in particular checking whether a securitisation meets the structural and transparency criteria to be recognised as high-quality. Nevertheless, SME insurers who may find such provisions difficult to implement are also less likely to invest in securitisation.. There is a positive impact for SMEs in general which will benefit from easier access to funding. This option will also have a beneficial impact for policyholders, by incentivising insurers to adopt a long-term investment strategy involving better quality assets. This effect is particularly important to counter the risks resulting from the current "hunt for yield" behaviour in the context of prolonged low interest rates, evidenced in EIOPA's Financial Stability reports[10] 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 Authorities[11].

6.2. Sound calibration of the equity risk dampener

According to the Directive, the standard formula for the calculation of the Solvency Capital Requirement must include an "equity dampener" to reflect the current levels of relative exuberance or depression of the equity market in the capital charge applied. The Directive does not however specify the time period over which the relative level of the market should be assessed, leaving this to the Delegated Acts, and specifying only that it should be determined over an 'appropriate period'. Two options were considered: average out the market values over the past 12 months (baseline); or average out the market values over a period of more than 12 months (36 months).

In a public consultation on this issue, while a few public authorities preferred a 12 month dampener, most respondents supported a longer period of 36 months. Using a longer averaging period (option 2) will allow insurers more time to adjust their investment strategies following a fall in the market and make it easier for them to adopt a more long-term perspective in their investment decisions. This will in turn be beneficial for the general economy, since it will serve to avoid pro-cyclical price movements and will encourage long-

[8] 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

[9] Only positions in senior tranches can qualify as high-quality securitisation positions.

[10] https://eiopa.europa.eu/en/publications/financial-stability/eiopa-financial-stability-reports/index.html

[11] https://eiopa.europa.eu/en/joint-committee/index.html

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term investment in equities including SMEs, who benefit from funding through private equity funds. The preferred option is therefore 36 months.

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

The Directive sets minimum quantitative requirements regarding the proportions of the SCR and MCR that must be covered by own funds of tiers 1, 2 and 3 (tier 1 being the highest quality), while including an empowerment for Delegated Acts in which stricter limits should be introduced by the Commission.

The preferred option is to apply stricter limits in respect of both SCR coverage and MCR coverage, while not requiring more than 50% of SCR to be covered by tier 1 capital. This ensures that the eligibility limits on tier 2 and tier 3 capital are not so restrictive as to make it impossible for mutual insurers, who cannot raise ordinary equity (tier 1), to recapitalise. This option is the most effective in improving risk-sensitivity because it effectively extends the ladder of supervisory intervention by allowing supervisors to intervene if the capital held by insurers is not sufficiently loss absorbent or permanent. It is also very efficient, since it is not likely to be very costly (it will not force healthy insurers to raise additional capital as the average share of Tier 1 capital on the market is well above the proposed limit). It is also coherent with the policy in other financial sectors, as the need for the predominant form of eligible own funds to be of high quality is also supported by the G20 and the Financial Stability Board.

6.4. Risk alignment and transparency of remuneration practices

The Solvency II Directive empowers the Commission to specify the elements of the system of governance[12], but it does not mention remuneration explicitly. 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.

The selected option is to require a remuneration policy, the principles of which must be publicly disclosed along with information on the individual and collective performance criteria. Other options were to have no remuneration requirements in the Delegated Acts, or to have more detailed disclosure than in the selected option.

The selected option is the most proportionate in achieving the objectives of the Commission recommendation on remuneration policies in the financial sector[13], and of the Green Paper on Corporate governance in financial institutions and remuneration policies[14], which calls for legislative measures in the insurance sector similar to those in the banking sector.

6.5. Harmonised and proportionate requirements on valuation

The Directive requires insurers to value their assets and liabilities in a market-consistent manner. It is left to the Delegated Acts to determine if and how specific accounting standards or methods should be used, such as IFRS or local GAAP.

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[12] Article 41(3) of the Directive, which is in the scope of the empowerment for Delegated Acts in article 50(1).
[13] Recommendation 2009/384/EC, 30 April 2009
[14] COM(2010)284 Final, 2 June 2010

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The chosen option is to require insurers that use IFRS for their financial statements to use IFRS for solvency purposes wherever IFRS provides for market-consistent valuation principles, but for the sake of proportionality, to allow undertakings to use other market-consistent valuation methods (based on the accounting standards already used in their financial statements) in cases where using IFRS would be overly costly. This strikes a balance between harmonisation and proportionality considerations as many smaller insurers use local GAAP and the use of IFRS would be overly burdensome. In many Member States, the local GAAP provide for market consistent valuation to a similar degree as IFRS.

6.6. Harmonised and proportionate requirements on supervisory reporting

The Directive empowers the Commission to harmonise the information to be reported to supervisors, in particular the information to be filed at predefined periods, while giving national supervisors the power to exempt smaller undertakings (representing up to 20% of each national market) of some of those reporting obligations. In the chosen option the reporting to supervisors is inludes annual quantitative reporting templates (QRTs) and only a subset of "core quantitative data" to be provided quarterly. This limited quarterly reporting satisfies the information needs for the supervisors on a timely manner without creating an excessive burden for insurers. According to the Directive (Article 35(10)), it is EIOPA which is empowered to draft Implementing Technical Standard specifying the actual information requested in those templates. The exemptions already laid down in the Directive for proportionality reasons (Article 35(6) and (7)) can be used to alleviate quarterly reporting obligations and any "item-by-item" reporting obligation in those templates.

7. BENEFITS AND COSTS OF THE PACKAGE

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 and transparency requirements. The requirements on quality of own funds going beyond the minimum imposed in the Directive may force a very small number of undertakings to raise additional own funds, but the latest quantitative impact studies evidence an average composition of own funds well above the proposed limits.

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, in particular infrastructure and SMEs. These benefits are considered to considerably outweigh the costs. There is no effect on the EU budget.

Overall, the options in the Delegated Regulation have a much smaller impact than other policy issues settled in the Directive, e.g. compared the impact of the long-term guarantees package introduced by Omnibus II which provided capital relief of €245bn for the EU life insurance industry alone[15]. In comparison, the order of magnitude of the cost impact of the current options is around or less than one billion euros.

[15] 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:

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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 regarding the composition of insurers' own funds	**Option 3**: applying stricter limits than the minimum 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 one 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 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 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: harmonised and proportionate requirements on reporting and disclosure	**Option 2**: require insurers to submit a regular supervisory report and quantitative reporting templates annually, with only a subset of core quantative templates to be submitted quarterly. The proportionality exemptions laid down in the Directive can apply to both types of templates.

8. MONITORING AND EVALUATION

The Delegated Regulation includes a review clause for the design and calibrations of the Standard Formula within three years of the application date. The review clause targets specifically the calculations for market risk, in particular fixed-income securities and long-term infrastructure.

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

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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 (in particular, securitisation products) will increase the availability of market data.

The review of the calibration for long-term infrastructure investments could build on the initiatives announced in the Communication of 27 March 2014 on the long-term financing of the European economy[16] (in its section 6) to collect comprehensive and standardised credit statistics on infrastructure on an international scale.

[16] COM 2014/168 final adopted on 27 March 2013.

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