28 February 2018

Review of the Solvency Capital Requirement (SCR) Standard Formula
Frequently Asked Questions

What was the objective of the Solvency Capital Requirement (SCR) standard formula review?

The objective of the review was to address the three priorities of the two calls for technical advice from the European Commission:

- First, on simplifications and proportionate application of the SCR requirements
- Second, on removal of technical inconsistencies, i.e. recalibration of certain risks and other technical issues
- Third, on removal of unjustified constraints to financing

With the SCR review, EIOPA started a rigorous, evidence-based and transparent review that aims to ensure a proportionate and technically consistent supervisory regime for (re)insurance undertakings.

Why did EIOPA decide to review the SCR standard formula after Solvency II being in place only for two years?

We appreciate of course the benefits of a period of stability. And the review overall does not propose radical change. On the other hand the review process is foreseen by legal texts (Recital 150 of the Solvency II Delegated Regulation). In addition, a number of the capital requirements were derived using information which is now several years old. Moreover, we now have evidence related to supervisory practice under Solvency II.

When will the SCR standard formula be finalised and what other reviews are expected?

The SCR review is planned to be finalised by the European Commission by the end of 2018.

The Delegated Solvency II Regulation also foresees the review of the Solvency II framework as a whole, including the treatment of long-term guarantees, to be completed by 2021.

What are the changes EIOPA proposes to achieve more simplicity and proportionality?

EIOPA proposes greater simplicity and/or proportionality in the following areas:

- Catastrophe risks
- Simplification of the look-through approach
- Look-through approach at group level
- Market risk concentration
- Currency risk at group level
- Simplification of the counterparty default risk module
- Reducing reliance on external credit ratings in the standard formula
- Treatment of guarantees, exposure guaranteed by a third-party and exposures to regional governments and local authorities (RGLA)
- Risk-mitigation techniques
- Undertaking specific parameters

EIOPA allows for more flexibility in the calculations so that, under credible evidence provided by insurers, proportionate formula can be applied to calculate the capital requirements. In many cases, this means applying simpler formulas and reducing the burden of insurers to collect granular data.

Why didn't EIOPA consider a cut in the risk margin?

The European Commission asked EIOPA to analyse the risk margin in particular the cost of capital, which is only one component of the risk margin.

EIOPA recommended no change to the current cost of capital based on careful analysis of different methodologies by which to calculate this cost.

EIOPA recommends consideration of the other components of the risk margin in the overall review of Solvency II due in 2021.

How did EIOPA take into account the views of different stakeholders?

The advice reflects intensive engagement of EIOPA with stakeholders since the start of the project and throughout its development.

In December 2016, EIOPA issued the first discussion paper seeking evidence and proposals from stakeholders to achieve the SCR standard formula review's objectives on a technically sound basis.

Two public consultations on the review of the SCR have been conducted. The first public consultation was conducted from 4 July 2017 to 31 August 2017 and the second one from 6 November 2017 to 5 January 2018.

On 23 May, 8 June and 27 September 2017, EIOPA held meetings with stakeholders and on 23 January and 30 January 2018, two teleconferences with stakeholders were organised.

EIOPA has been also in dialogue with its Insurance and Reinsurance Stakeholder Group.

In its first advice EIOPA's analysis showed divergent supervisory practices with regard to 25% of loss absorbing capacity of deferred taxes (LAC DT). What does EIOPA propose to achieve greater convergence in this area?

EIOPA proses a set of key principles which are intended to strike a reasonable balance between flexibility and fostering greater supervisory convergence.

LAC DT allows insurers to offset loss with future profits to a certain extent. EIOPA specifies the assumptions with which these future profits should be calculated.

Assumptions on future profits of the new business should not be more favourable than that of the business plan.

Assumptions on return on assets should be set prudently and credible evidence should be provided where returns higher than risk-free rates are assumed.

The governance around these projections should be reinforced by the involvement of key functions and in particular the actuarial function.

Appropriate public disclosure and supervisory reporting is recommended so that all can assess the extent to which insurers are relying on taxes to absorb losses.

What is EIOPA's proposal with respect to interest rate risk?

The current approach for calculating capital requirements to cover for interest rate risk does not cover for negative interest rates and is not effective when interest rates are low.

The proposed approach, supported by most stakeholders and used in internal models, corrects this unintended technical inconsistency.
The impact has been assessed with due care and EIOPA proposes that it be gradually implemented over the next three 3 years.

What is EIOPA's proposal regarding the treatment of unrated debt and unlisted equity?

With respect to the treatment of unrated debt and unlisted equity, EIOPA recommends circumstances and objective criteria when these important asset classes can be given the same treatment as rated debt and listed equity.
On unrated debt, the criteria relate to certain financial ratios and to the yield of the debt. Further requirements on governance and risk management have been advised as well.
On unlisted equity, the criteria relate to the underlying equity investments and to own risk management.

What are the results of EIOPA's impact assessment?

The impact of EIOPA's advice has been assessed on each topic separately and all topics together.
One of the objectives of the review was to simplify the standard formula. Considering the implementation costs the industry already incurred, EIOPA has, in most cases, advised for optional simplifications. This also allows greater flexibility in the regime and ensures a proportionate application of the requirements.