Final Report
on
Public Consultation No. 14/036 on
Guidelines on
look-through approach
Table of Contents

1. Executive summary ................................................................. 3
2. Feedback statement ................................................................. 5
Annex: Guidelines ........................................................................ 7
1. Executive summary

Introduction

According to Article 16 of Regulation (EU) No 1094/2010 (EIOPA Regulation) EIOPA may issue guidelines addressed to National Competent Authorities (NCAs) or financial institutions.

According to Article 16 of the EIOPA Regulation, EIOPA shall, where appropriate, conduct open public consultations and analyse the potential costs and benefits. In addition, EIOPA shall request the opinion of the Insurance and Reinsurance Stakeholder Group (IRSG) referred to in Article 37 of the EIOPA Regulation.

According to Article 84 of the Implementing Measures undertakings have to apply the look-through approach to collective investment undertakings, other investments packaged as funds and indirect exposures to market, counterparty and underwriting risk. As stakeholders ask many questions on this topic and it can have a meaningful impact on the regulatory capital requirements EIOPA decided to issue Guidelines.

As a result of the above, on 2 June 2014 EIOPA launched a Public Consultation on the draft guidelines on the look-through approach. The Consultation Paper is also published on EIOPA’s website.

These guidelines were issued to undertakings and NCAs to:

- Establish consistent, efficient and effective supervisory practices;
- Ensure the common, uniform and consistent application of Union law on the look-through approach.

Content

This Final Report includes the feedback statement to the consultation paper (EIOPA-CP-14/036) and the Guidelines. The Impact Assessment and cost and benefit analysis, and the Resolution of comments are published on EIOPA’s website.

---

Next steps

In accordance with Article 16 of the EIOPA Regulation, within 2 months of the issuance of these guidelines, each competent authority shall confirm if it complies or intends to comply with these guidelines. In the event that a competent authority does not comply or does not intend to comply, it shall inform EIOPA, stating the reasons for non-compliance.

EIOPA will publish the fact that a competent authority does not comply or does not intend to comply with these guidelines. The reasons for non-compliance may also be decided on a case-by-case basis to be published by EIOPA. The competent authority will receive advanced notice of such publication.

EIOPA will, in its annual report, inform the European Parliament, the Council and the European Commission of the guidelines issued, stating which competent authority has not complied with them, and outlining how EIOPA intends to ensure that concerned competent authorities follow its guidelines in the future.
2. Feedback statement

Introduction

EIOPA would like to thank the Insurance and Reinsurance Stakeholder Group (IRSG) and all the participants to the Public Consultation for their comments on the draft guidelines. The responses received have provided important guidance to EIOPA in preparing a final version of these guidelines. All of the comments made were given careful consideration by EIOPA. A summary of the main comments received and EIOPA’s response to them can be found in the sections below. The full list of all the comments provided and EIOPA’s responses to them is published on EIOPA’s website.

General comments

1. Look-through for unit-linked contracts

   a) It was suggested that unit-linked products should not be subject to the look-through approach provided the market risk is not significant.

   b) EIOPA is of the view that Guidelines cannot exempt any exposures from the application of look-through approach which the Implementing Measures would require.

2. Necessary information for the application of Article 84 (3) DA

   a) It was commented that it might not be possible for undertakings to access the necessary information to identify “the nature of all underlying assets” for the calculation of the Solvency Capital Requirement as required in Guideline 3. As an alternative it was suggested to clarify that the "necessary information to identify the nature of all underlying assets" refers to having the target asset allocation at a sufficient level of granularity and appropriate evidence that the fund is strictly managed according to this allocation.

   b) EIOPA does not disagree. But as after the suggested redraft the Guideline would replicate provisions already covered by the Implementing Measures, EIOPA has deleted the whole Guideline 3.

3. Groupings across credit quality steps

   a) It was commented that prudent groupings across different credit quality steps should also be allowed.

   b) EIOPA has changed the Guideline accordingly.

4. Market risk concentration capital charge for non-existing single name

   a) It was commented that Guideline 6 could generate a large capital charge for market risk concentration for a non-existing single name exposure because all exposures where the single name is not known are to be grouped together. Specific concerns were voiced that this would overstate the risk when the investment fund is managed according to specific exposure limits.
b) EIOPA agrees that this situation could arise. The Guideline will be maintained as Article 84 (3) DA requires that groupings are applied in a prudent manner; however, the Guideline has been amended. It now allows for cases where single name exposures are not identified but the fund is managed according to specific exposure limits to counterparties and it may therefore not be appropriate to treat them as one single name exposure.

**General nature of the participants to the Public Consultation**

EIOPA received comments from the Insurance and Reinsurance Stakeholder Group (IRSG) and six responses from other stakeholders to the public consultation. All the comments received have been published on EIOPA’s website.

Respondents can be classified into three main categories: European trade, insurance, or actuarial associations; national insurance or actuarial associations; and other parties such as consultants and lawyers.

**IRSG opinion**

The IRSG opinion on the draft set 1 of the Solvency II Guidelines on Pillar 1 and Internal Models, as well as the particular comments on the Guidelines at hand, can be consulted on EIOPA’s website⁴.

**Comments on the Impact Assessment**

A separate Consultation Paper was prepared covering the Impact Assessment for the Set 1 of EIOPA Solvency II Guidelines. Where the need for reviewing the Impact Assessment has arisen following comments on the guidelines, the Impact Assessment Report has been revised accordingly.

The revised Impact Assessment on the Set 1 of EIOPA Solvency II Guidelines can be consulted on EIOPA’s website.

---

Annex: Guidelines

1. Guidelines on look-through approach

Introduction


1.3 These Guidelines are addressed to supervisory authorities under Solvency II.

1.4 These Guidelines aim at increasing consistency and convergence of professional practice in the application of the look-through approach for all types and sizes of solo undertakings using the standard formula across Member States.

1.5 These Guidelines aim at supporting undertakings in calculating their market risk related Solvency Capital Requirements under Solvency II.

1.6 Only cases that do not already qualify as risk-mitigation techniques are considered for potential application of the look-through approach. Where insurance or reinsurance undertakings use risk-mitigation techniques the assumption is that the underlying risks are understood and have already been looked-through.

1.7 If not defined in these Guidelines the terms have the meaning defined in the legal acts referred to in the introduction.

1.8 The Guidelines shall apply from 1 April 2015.

Guideline 1 – Money market funds

1.9 Undertakings should apply the look-through approach to money market funds.

Guideline 2 – Number of iterations

1.10 Undertakings should perform a sufficient number of iterations of the look-through approach, where appropriate (e.g. where a fund is invested in other funds) to capture all material risk.

\(^5\) OJ L 331, 15.12.2010, p. 48–83
Guideline 3 – Investments in real estate

1.11 Undertakings should cover the following investments in the property risk sub-module:
   (a) land, buildings and immovable property rights;
   (b) property investment held for the own use of the undertaking.

1.12 For equity investments in a company exclusively engaged in facility management, real estate administration, real estate project development or similar activities, undertakings should apply the equity risk sub-module.

1.13 Where undertakings invest in real estate through collective investment undertakings or other investments packaged as funds, they should apply the look-through approach.

Guideline 4 – Data groupings

1.14 With reference to the groupings referred to in Article 84 (3) of the Implementing Measures, where assets covered in the spread and interest rate risk sub-modules are grouped according to duration bands, undertakings should ensure that the durations assigned to the bands are demonstrably prudent.

1.15 Where groupings across different credit quality steps are used, undertakings should ensure that the credit quality steps assigned to the groups are demonstrably prudent.

Guideline 5 – Data groupings and concentration risk

1.16 Where in accordance with Article 84 (3) of the Implementing Measures, any grouping is applied to the single name exposures of the underlying assets of collective funds for calculating the market risk concentration charge and it cannot be demonstrated that the groups into which the fund is split do not contain any of the same single name exposures, undertakings should assume that all assets for which the actual single name exposure is not identified belong to the same single name exposure.

1.17 The above paragraph is not applicable where exposure limits to single name exposures exists according to which the fund is managed.

1.18 Undertakings should aggregate exposures to groups referred to in paragraph 1.16 across all collective funds in which they are invested and reconcile the exposures to each group with the exposures of the known single names in their asset portfolio.

Guideline 6 – Indirect exposure to catastrophe risk

1.19 When calculating the Solvency Capital Requirement in respect of indirect exposures to catastrophe risks, such as investments in bonds for which
repayment is contingent on the non-occurrence of a given catastrophe event, undertakings should take into account any credit and catastrophe exposures.

1.20 Catastrophe exposures should be treated in the relevant catastrophe sub-modules as though the underlying catastrophe exposure is directly held by the undertaking.

Guideline 7 – Catastrophe bonds issued by the undertaking

1.21 Where an undertaking issues catastrophe bonds which do not meet the requirements for risk-mitigation techniques set out in Articles 208 to 215 of the Implementing Measures, their treatment in the standard formula should not result in a capital relief in respect of the catastrophe features of these bonds.

1.22 Undertakings should treat these catastrophe bonds in the calculation of the Solvency Capital Requirement as though the repayment schedule was not contingent on the non-occurrence of a catastrophe event.

Guideline 8 – Longevity bonds

1.23 Where undertakings buy longevity bonds which do not meet the requirements for risk-mitigation techniques set out in Articles 208 to 215 of the Implementing Measures, they should calculate the capital charge in respect of mortality and spread risk as set out in paragraphs 1.24 to 1.28.

1.24 The capital charge of the standard formula mortality sub-module should be based on a notional portfolio of term assurance contracts:
   (a) paying out the given sum on death;
   (b) based on a representative sample of the reference population underlying the longevity index;
   (c) where the term of each term assurance contract is equal to the term of the coupon payment.

1.25 The notional portfolio should be constructed by undertakings in such a way that under best estimate assumptions the total benefit payments sum to the coupon payable.

1.26 The capital charge of the spread risk sub-module should be based on a bond or a loan with the same market value, duration and credit quality step as the longevity instrument.

1.27 Where undertakings sell longevity bonds they should calculate the capital charge in respect of the longevity sub-module as though the notional portfolio consists of endowment contracts, paying out the required sum at survival to a given age, which collectively produce cash-flows equivalent to those of the bond.

1.28 Undertakings should not consider longevity bonds which do not meet the requirements for risk-mitigation techniques set out in Articles 208 to 215 of the
Implementing Measures to increase in value when the stresses in the life underwriting risk module are applied.

**Compliance and Reporting Rules**

1.29 This document contains Guidelines issued under Article 16 of the EIOPA Regulation. In accordance with Article 16(3) of the EIOPA Regulation, Competent Authorities and financial institutions shall make every effort to comply with guidelines and recommendations.

1.30 Competent authorities that comply or intend to comply with these Guidelines should incorporate them into their regulatory or supervisory framework in an appropriate manner.

1.31 Competent authorities shall confirm to EIOPA whether they comply or intend to comply with these Guidelines, with reasons for non-compliance, within two months after the issuance of the translated versions.

1.32 In the absence of a response by this deadline, competent authorities will be considered as non-compliant to the reporting and reported as such.

**Final Provision on Reviews**

1.33 The present Guidelines shall be subject to a review by EIOPA.
2. Explanatory text

Guideline 5 – Data groupings and concentration risk

Where in accordance with Article 84 (3) of the Implementing Measures, any grouping is applied to the single name exposures of the underlying assets of collective funds for calculating the market risk concentration charge and it cannot be demonstrated that the groups into which the fund is split do not contain any of the same single name exposures, undertakings should assume that all assets for which the actual single name exposure is not identified belong to the same single name exposure.

The above paragraph is not applicable where exposure limits to single name exposures exists according to which the fund is managed.

Undertakings should aggregate exposures to groups referred to in paragraph 1.16 across all collective funds in which they are invested and reconcile the exposures to each group with the exposures of the known single names in their asset portfolio.

2.1. Consider for instance an undertaking which holds 40% of its total assets in 5 separate collective funds with different fund managers. The undertaking has arranged with each of the fund managers to provide the details on the \( n_i \) largest single names within each fund, where \( n_i \) is selected for each fund \( i \) in such a way that on aggregate half of the total funds are effectively looked-through. This leaves only 20% of total assets to which the fund applies grouping – thereby fulfilling the restriction given in Article 84 (3) of the Implementing Measures.

2.2. For the 20% which is grouped, fund managers provide the breakdown into 21 groups, none of which contain any of the same single name exposures.

2.3. The undertaking then needs to reconcile the exposures in the 20% of total assets that were already grouped with the single name exposures in the remaining 80% of total assets for which it has definite single names – both for the 20% of fund assets for which single names are provided by fund managers, and for the remaining 60% of the total assets which are not held in collective funds. This can be done by allocating 80% of the assets with definite single name exposures into the 21 groups (defined in 2.2) and adding the grouped exposure to it.

2.4. For example, if Bank X is identified as the largest known single name exposure in a group, then the total exposure of the group will be added to this single name exposure when determining the concentration risk charge. Where there are no definite single name exposures in a group, the total exposure will consist of the grouped exposure only.

2.5. The undertaking can then determine its excess exposures for the market concentration risk module according to these exposures, which will in all cases
be prudent estimates, since concentrations can only be overstated and not understated.

**Guideline 6 – Indirect exposure to catastrophe risk**

When calculating the Solvency Capital Requirement in respect of indirect exposures to catastrophe risks, such as investments in bonds for which repayment is contingent on the non-occurrence of a given catastrophe event, undertakings should take into account any credit and catastrophe exposures.

Catastrophe exposures should be treated in the relevant catastrophe sub-modules as though the underlying catastrophe exposure is directly held by the undertaking.

2.6. Catastrophe bonds are risk-linked securities which are generally used by (re)insurance undertakings to transfer some of their underwriting exposure to capital markets. If no catastrophe occurs, they pay a coupon to investors; in case of a catastrophe, the principal is forgiven and insurers are free to use these funds to cover the claims they incur.

2.7. The trigger may be indemnity (based on insurer’s actual losses), based on a modelled loss, indexed to industry losses, parametric (based on a specified event such as ground speeds of winds reaching a certain threshold) or based on a parametric index (models give an approximation of loss based on the specified events to more closely match actual insurer loss).

2.8. Cat bonds are usually rated by an external rating agency. But where a typical corporate bond is rated based on the probability of default due to issuer bankruptcy, a catastrophe bond is rated based on the probability of default due to a qualifying catastrophe triggering the loss of principal.

**Guideline 8 – Longevity bonds**

Where undertakings buy longevity bonds which do not meet the requirements for risk-mitigation techniques set out in Articles 208 to 215 of the Implementing Measures, they should calculate the capital charge in respect of mortality and spread risk as set out in paragraphs 1.24 to 1.28.

The capital charge of the standard formula mortality sub-module should be based on a notional portfolio of term assurance contracts:

(a) paying out the given sum on death;

(b) based on a representative sample of the reference population underlying the longevity index;

(c) where the term of each term assurance contract is equal to the term of the coupon payment.

The notional portfolio should be constructed by undertakings in such a way that under best estimate assumptions the total benefit payments sum to the coupon payable.

The capital charge of the spread risk sub-module should be based on a bond or a
loan with the same market value, duration and credit quality step as the longevity instrument.

Where undertakings sell longevity bonds they should calculate the capital charge in respect of the longevity sub-module as though the notional portfolio consists of endowment contracts, paying out the required sum at survival to a given age, which collectively produce cash-flows equivalent to those of the bond.

Undertakings should not consider longevity bonds which do not meet the requirements for risk-mitigation techniques set out in Articles 208 to 215 of the Implementing Measures to increase in value when the stresses in the life underwriting risk module are applied.

2.9. Undertakings are not required to calculate technical provisions for notional portfolios, as they are only used for the purpose of calculating the capital requirements.

2.10. Longevity bonds pay a coupon that is proportional to the number of survivors in a selected birth cohort. The greater the number of survivors under such arrangements, the greater the coupon that is payable. These assets can therefore present a good risk-mitigation tool for insurers with significant longevity exposure (subject to the basis risk that may be present between the actual incurred losses and the payouts under the bond). The ratings of longevity bonds are based on the credit quality of the issuer and do not incorporate possible losses attributable to the longevity exposure.

2.11. Consider as an example a two-year bond which pays a coupon of 5% of the face value at the end of years 1 and 2 and is redeemed at face value at the end of the two years. Each payment is proportional to the number of survivors in a cohort that starts with 1000 well-diversified lives living within the EU.

2.12. The undertaking holding such a bond is required to take a representative sample of the lives and assume that they hold term assurances maturing in one year with a cumulative value of 5% of the face value and in two years with a cumulative value of the face value plus the 5% coupon. The mortality stress under the standard formula for this instrument can then be calculated based on this notional portfolio.