

15 January 2020

European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main
Germany

Dear Sir or Madam

EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (the "**Solvency II Directive**") came into force on 1 January 2016. The Solvency II Directive sets out regulatory requirements for insurance firms and groups, covering financial resources, governance and accountability, risk assessment and management, supervision, reporting and public disclosure. In February 2019, the European Commission asked the European Insurance and Occupational Pensions Authority ("**EIOPA**") to provide technical advice for a comprehensive review of the Solvency II Directive (the "**Call for Evidence**").¹ EIOPA, accordingly, issued a Consultation Paper on the Opinion on the 2020 review of Solvency II (the "**Consultation Paper**") in October 2019.² The Committee is grateful for the opportunity to comment on a few key issues.

Freedom to provide services and freedom of establishment

The principles of freedom of establishment and freedom to provide services are derived from Articles 49 and 56 of the Treaty on the Functioning of the European Union. These rights, known collectively as "passporting" rights, are exercised where a (re)insurance policy is entered into by, or on behalf of, a (re)insurer incorporated and authorised in one member state (the "**Home Member State**") for the benefit of a policyholder who is resident in, or operating for purposes of the policy in, another member state (the "**Host Member State**").³ These freedoms underpin several provisions of the Solvency II Directive. The European Commission asks EIOPA to assess whether the current supervisory powers at the disposal of the home National Supervisory Authorities ("**NSAs**") and EIOPA are sufficient to prevent failures of insurance companies operating across borders on the basis of the two freedoms.

EIOPA makes two recommendations which the Committee is concerned raise legal uncertainty. The first is a recommendation, in paragraph 10.20 of the Consultation Paper, to amend Article 18 of the Solvency II Directive. Article 18 sets out the conditions which every insurance or reinsurance provider must meet for authorisation. EIOPA recommends a new requirement be added under Article 18 obliging an insurance or reinsurance undertaking applying for authorisation to establish to disclose any "formal or informal request for an authorisation" in another Member State or Third Country which has been rejected or withdrawn and providing the reasons for rejection or withdrawal. EIOPA explains in paragraph 10.17 that the new requirement would increase transparency between NSAs and reduce regulatory arbitrage.

The second recommendation in this respect is made by EIOPA in paragraph 10.29. EIOPA recommends that a second prong be added to Article 149 requiring an

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insurance undertaking to inform the supervisory authority of the home Member State immediately “in case of any material change in the business pursued by the insurance undertaking under the freedom to provide services”.

Both recommendations introduce a degree of ambiguity to the obligations imposed on insurance undertakings. As to the former, an element of uncertainty arises in respect of what might be considered an “informal” request and whether, for example, a conversation or meeting with the regulator at which there is a discussion about the possibility of an application might fall within the definition. As the regulated entity could be sanctioned for not disclosing an informal request that is withdrawn, more clarity about what constitutes an “informal request” would be helpful. In the second recommendation, the introduction of the phrase “material change” raises uncertainty. In the absence of guidance or definition, there is a risk of divergence in interpretation across Member States.

Expected Profits in Future Premiums

Expected Profits In Future Premiums (“EPIFP”) reflects the profit embedded in future premiums and it is sometimes seen as the impact of future premium in the own funds. Paragraph 3.32 of the Consultation Paper notes that the definition of EPIFP, provided in Article 260(2) of the Commission Delegated Regulation (EU) 2015/35 on the taking-up and pursuit of the business of Insurance and Reinsurance (the “**Delegated Regulation**”), does not reflect the real impact in own funds of future premiums.⁴ One of the reasons for this, EIOPA notes, is that EPIFP are calculated without fully considering loss-making policies. EIOPA recommends that the first line of Article 260(2) of the Delegated Regulation is amended to state: “The gross expected profit or loss included in future premiums shall be calculated ...” It is not entirely clear that the addition of “loss” is necessary: arguably, the best estimate takes account of all cash inflows and outflows and a loss-making contract would therefore reduce the excess of assets over liabilities in any event.

Article 260(4) of the Delegated Regulation states that loss-making policies can be offset only against profit-making policies within the same homogeneous risk group. EIOPA also suggests an additional sentence be added to Article 260(4) so that it states:

Loss-making policies may only be offset against profit-making policies within a homogeneous risk group. **Profit-making homogeneous risk groups shall be used to calculate gross expected profits in future premiums and loss-making homogeneous risk groups shall be used to calculate gross expected losses in future premiums.**

It is not clear whether the additional wording in Article 260(4) refers to homogeneous risk groups which are overall profit-/loss-making, or which consist only of profit-/loss-making contracts.

Finally, EIOPA also proposes two new paragraphs to Article 260 of the Delegated Regulation to address issues relating to the impact of reinsurance contracts and special purpose vehicles (“SPV”) on the gross expected profit or loss included in future premiums. The drafting seems to be based on an assumption that the receipt of future premiums under the underlying insurance contracts has, of necessity, a direct impact on the reinsurance receivable or the receivable from an associated SPV. The Committee is not persuaded that this is necessarily the case.

Long-term guarantee measures

The long-term guarantees (“LTG”) measures were introduced in the Solvency II Directive to ensure an appropriate treatment of insurance products that include long-term guarantees.⁵ Section 2.3.4 of the Consultation Paper deals with the asset eligibility criteria for two of the LTG measures: the matching adjustment and the volatility adjustment.

Under the Solvency II Directive, insurers are required to calculate the value of their liabilities using a risk-free interest rate. The matching adjustment, provided in Article 77b, is an upward adjustment to the risk-free rate where insurers hold certain long-term assets with cashflows that match the liabilities.⁶ It reflects the fact that long-term investors are not exposed to spread movements in the same way as short-term traders of such assets might be. Article 77d of the Solvency II Directive makes provision for the volatility adjustment. This is a measure to ensure the appropriate treatment of insurance products with long-term guarantees under the Solvency II Directive. (Re)insurers are allowed to adjust the risk-free rate to mitigate the effect of short-term volatility of bond spreads on their solvency position so as to prevent pro-cyclical investment behaviour of (re)insurers.

In paragraph 2.3.6, EIOPA advises that the following additional requirement is introduced to clarify the eligibility of restructured assets:

For assets whose cash flows depend on the performance of other underlying financial assets, undertakings shall be able to demonstrate that, in addition to meeting the other MA eligibility criteria,

1. the underlying assets provide a sufficiently fixed level of income;
2. [...]

The Committee notes the ambiguity in the proposed drafting of these provisions, including in the term “underlying financial assets”. The reference to a “sufficiently fixed level of income” is similarly unclear and appears also to be inconsistent with the requirement in Article 77b 1(h) which provides that a matching adjustment may be applied to the relevant risk-free interest rate term structure subject to prior approval by the supervisory authorities where the cash flows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties. (This is in addition to the other conditions in which matching adjustment may be applied provided in Article 77 b 1(a) to (i).)

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,


Joanna Perkins
FMLC Chief Executive⁷

¹ European Commission, *Request to EIOPA for Technical Advice on the Review of the Solvency II Directive* (Ref. Ares(2019)782244), (11 February 2019), available at: https://eiopa.europa.eu/Publications/Requests%20for%20advice/RH_SRAnnex%20-%20CfA%202020%20SII%20review.pdf.

² EIOPA, *Consultation Paper on the Opinion on the 2020 review of Solvency II*, (15 October 2019), available at: <https://eiopa.europa.eu/Pages/Consultation-Paper-on-the-Opinion-on-the-2020-review-of-Solvency-II.aspx>.

³ The Home Member State of a (re)insurance undertaking is defined in the Solvency II Directive as the Member State in which the head office of the undertaking covering the risk (for non-life insurance) or the commitment (for life insurance) is located. Each other Member State into which the (re)insurance undertaking may wish to provide services is the Host Member State.

⁴ Article 260(2) the Delegated Regulation provides:

The expected profit included in future premiums shall be calculated as the difference between the technical provisions without a risk margin calculated in accordance with Article 77 of that Directive and a calculation of the technical provisions without a risk margin under the assumption that the premiums relating to existing insurance and reinsurance contracts that are expected to be received in the future are not received for any reason other than the insured event having occurred, regardless of the legal or contractual rights of the policyholder to discontinue the policy

⁵ The LTG measures include the extrapolation of risk-free interest rates, the matching adjustment, the volatility adjustment, the extension of the recovery period in case of non-compliance with the Solvency Capital Requirement, the transitional measure on the risk-free interest rates and the transitional measure on technical provisions.

⁶ Articles 77a to 77f were added to the Solvency II Directive by Directive 2014/51/EU in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority).

⁷ The FMLC is grateful to Peter Bloxham, Beth Dobson (Slaughter and May), David Kendall (Cooley (UK) LLP) and Adam Levitt (Ashurst LLP) for their contributions to this letter.