

# EIOPA Final Guidelines on the preparation for Solvency II

October 2013



EIOPA's final guidelines for supervisors on the preparation for Solvency II closely mirror the draft guidelines previously released for consultation in March 2013.

## INTRODUCTION

On 27 September 2013 EIOPA published its final guidelines on the preparation for Solvency II following a public consultation earlier this year. The guidelines are aimed at National Competent Authorities ("**NCA**s") and allow for the phased introduction of specific aspects of the Solvency II requirements into national supervision from 1 January 2014. The following key areas are each covered by a separate set of guidelines (with accompanying explanatory text):

- System of governance
- Forward looking assessment of the undertaking's own risk (based on Own Risk and Solvency Assessment ("**ORSA**") principles)
- Submission of information to NCAs
- Pre-application for internal models

To assist you in digesting these guidelines, Milliman has prepared this summary paper.

Some key points to note are:

- Under the forward looking assessment of the undertaking's own risk ("**FLAOR**"), the assessment of solvency needs will be required in 2014 irrespective of discussions on the Omnibus II Directive ("**OMDII**") and the Solvency II start date.
- Under the FLAOR, the assessment of continuous compliance and the assessment of deviation from Solvency Capital Requirement ("**SCR**") assumptions have been deferred until 2015 for all undertakings.
- In relation to the submission of information, only one quarterly submission is required prior to Solvency II implementation and an extra two weeks has been granted to meet the deadline for the annual submission.

- Dates for the submission of information will be reviewed at the end of 2013 based on the latest developments with regard to OMDII.
- Some materiality thresholds and exemptions have been introduced in relation to the submission of information in the interests of proportionality, mainly regarding the quarterly preparatory submission.
- Under the system of governance, some of the actuarial function requirements relating to valuation have been removed.
- Under the pre-application for internal models, the standard formula SCR is also required to be submitted to the NCA.

## OVERVIEW

In all four documents, EIOPA has set out general comments under several headings including:

### Purpose of the preparatory phase

EIOPA states that NCAs and undertakings are expected to progress in their preparedness for Solvency II during the course of the preparatory phase. As a result EIOPA expects undertakings to be able to perform the FLAOR in both 2014 and 2015 and to submit reporting information in 2015.

### Enforcement measures and supervisory actions

EIOPA states that the way each NCA incorporates the EIOPA guidelines into its supervisory framework is at the discretion of each NCA. However EIOPA expects that a dialogue will take place between NCAs and undertakings during the preparatory phase. The Central Bank has indicated to industry that it will be in a position to comply with the guidelines based on the existing structures in place, including the Corporate Governance Code and the Fitness & Probity regime, plus the introduction of new Irish guidelines to address specific requirements of the EIOPA guidelines.

EIOPA notes in particular that the guidelines do not require supervisory action for failure to comply with Pillar I during the preparatory phase.

EIOPA gives the following two examples of when supervisory action would be expected:

- Undertakings should take into account information arising from the FLAOR or from the implementation of the system of governance in business planning.
- NCAs should review the quality of information received and may take action if the quality of information raises concerns (but not if the Own Funds are lower than the SCR).

*EIOPA has made it clear that it is not advising supervisory action if Pillar 1 requirements are breached during the preparatory phase.*

*It is not clear what supervisory actions EIOPA is expecting in relation to Pillar II or III, aside from the two examples given.*

#### **Status of Solvency II Directive and the Delegated Acts (Implementing Measures and Technical Standards)**

EIOPA highlights that the current working assumption for the preparatory guidelines is that Solvency II will be applicable from 1 January 2016.

EIOPA is working under the assumption that OMDII and the Delegated Acts will be available in time for NCAs and undertakings to prepare for the submission of the FLAOR (mainly relevant for the second FLAOR due in 2015) and the quantitative and qualitative information due in 2015.

The dates for the submission of information and for the assessment of continuous compliance and the assessment of deviation from SCR assumptions under the FLAOR will be reviewed at the end of 2013 based on the latest OMDII developments. EIOPA expects one quarterly submission and one annual submission of reporting information in advance of the finally agreed Solvency II commencement date.

*Latest indications are that discussions on OMDII may be concluded in time for approval at the European Parliament plenary session on 3 February 2014. Official publication of the Omnibus II Directive is expected 2 months after the plenary vote.*

#### **Minimum or maximum harmonisation**

EIOPA states that NCAs may go further than the guidelines issued by EIOPA.

#### **Application by third countries**

EIOPA states that it does not expect supervisory authorities in third countries (i.e. countries outside the EU) to apply the preparatory Guidelines.

Also when referring to group structures the guidelines apply to EEA groups only.

In relation to the submission of information it states that the regulatory regime in all third countries would be considered "equivalent" to Solvency II during the preparatory phase when the deduction and aggregation method is applied.

However in relation to the system of governance and FLAOR, EIOPA states that it "assumes that third country supervisors have similar parts of risk management in their national requirements, as the preparatory Guidelines where these follow international standards".

*EIOPA has made it clear that third country supervisors are not expected to implement the guidelines and third countries will be considered equivalent for the purposes of Pillar III (when the deduction and aggregation method is applied).*

*However in relation to Pillar II it is not clear what is expected of undertakings or of EEA supervisors in ensuring that the guidelines are satisfied where third country undertakings are involved.*

#### **Comply-or-explain mechanism**

NCAs have to report to EIOPA on whether they comply or intend to comply with each guideline within 2 months of the official publication of the guidelines. If they do not comply with a guideline they need to provide the reasons for non-compliance. This report is expected to be required by end December 2013.

The answers on comply-or-explain provided by NCAs will be made publicly available by EIOPA. In the cases of non-compliance, the reasons will be kept confidential unless agreed otherwise by the Board of Supervisors.

## Progress report

NCAs are required to submit progress reports to EIOPA. The first progress report should be submitted by 28 February 2015, based on the period from 1 January 2014 to 31 December 2014.

## FORWARD LOOKING ASSESSMENT OF OWN RISK

The final 25 guidelines for the preparation of the FLAOR are largely unchanged from the draft consultation guidelines.

There are three main aspects to the FLAOR:

1. Assessment of overall solvency needs;
2. Assessment of whether the undertaking would comply on a continuous basis with Solvency II regulatory capital requirements and the requirements regarding the calculation of technical provisions;
3. Assessment of whether the undertaking's risk profile deviates from the assumptions underlying the SCR calculation.

EIOPA has deferred the second two aspects until 2015 for all undertakings. Thresholds for the scope of these two aspects are unchanged from the draft consultation guidelines.

However the assessment of overall solvency needs will be required during 2014 irrespective of OMDII discussions and the Solvency II start date.

EIOPA addresses the specific issues raised by stakeholders under several headings including:

### Link to the agreement for OMDII

The assessment of the overall solvency needs of an undertaking is seen by EIOPA as independent of the result of the discussions on OMDII. So the assessment is required on a "best effort basis" from the year 2014 onwards.

The assessment of continuous compliance and the assessment of deviation from SCR assumptions have been deferred until 2015 for all undertakings on the assumption of a Solvency II start date of 1 January 2016. EIOPA will review the deadlines for these assessments at the end of 2013 based on the latest developments.

EIOPA will prepare technical specifications on Pillar I quantitative issues and provide guidance on the assumptions underlying the calculation of the standard formula calculation in 2014.

## Internal model users

EIOPA states that internal model users cannot be sure that their internal model will meet all necessary requirements for supervisory approval by the time Solvency II starts. They have to consider what their regulatory capital requirements could amount to if they have to use the standard formula at first as well as the capital planning implications. (This is also mentioned in the submission of information guidelines and the internal model guidelines.)

### Timing and application issues

EIOPA considers it necessary that all undertakings perform the assessment of the overall solvency needs at least twice during the preparatory phase, once in 2014 and once in 2015.

The reference date for the FLAOR would normally be the same as the SCR calculation date but does not necessarily have to be the SCR calculation at 31 December of a particular year. It could be the SCR calculation at any time during the year.

### Documentation

EIOPA expects undertakings during the preparatory phase to submit the supervisory report on the results and conclusion of the FLAOR to the NCA within two weeks of having finished the assessment. Note that the policy document, the record of the FLAOR and the internal report are also expected to be in place.

### Valuation and recognition of the overall solvency needs

EIOPA has amended guideline 11 to clarify that the quantitative impact of using a different recognition and valuation bases to the Solvency II bases is expected on a "best effort basis" during the preparatory phase. Also this quantitative estimate is only required in 2015 (assuming EIOPA has provided the technical specifications by that point).

### Assessment of the significance of the deviation of the risk profile

EIOPA has amended guideline 16 to reflect that quantification is not necessary if a qualitative assessment indicates that the deviation is not significant.

### Group FLAOR

EIOPA states that non EEA entities that are within the scope of group supervision for a group based in

the EEA should be included in the group FLAOR assessment, even if these non EEA entities do not have to perform a FLAOR at individual level.

If a group decides to apply for the use of a single group FLAOR document, the Administrative, Management or Supervisory Body (“**AMSB**”) of the individual undertaking is responsible for ensuring that the risks related to the individual undertaking are properly represented in the single group FLAOR.

Groups using a (partial) internal model are not required to assess the deviation of the risk profile from the assumptions underlying the SCR for the group FLAOR. (Undertakings using an internal model are not required to perform this assessment during the preparatory phase). However individual undertakings using the standard formula would be expected to perform this assessment on an individual entity level.

### SUBMISSION OF INFORMATION

The 38 submission of information guidelines included in the draft consultation have been increased to 39, but this reflects a reformat of one of the guidelines rather than new content. The guidelines are grouped as follows:

- General provisions for Guidelines (Guidelines 1-2)
- Scope of the submission of information – Thresholds to be applied (Guidelines 3-12)
- Quantitative information (Guidelines 13-20)
- Narrative information on System of governance (Guidelines 21-27)
- Narrative information on Capital management (Guideline 28)
- Narrative information on Valuation for solvency purposes (Guidelines 29-33)
- Reporting process and undertakings’ reporting policy (Guideline 34)
- Dates of initial application and deadlines (Guideline 35)
- Means for reporting, currency, units and data checks and others (Guidelines 36-39)

EIOPA has concluded that one quarterly submission prior to Solvency II implementation is sufficient i.e. Q3 2015 if 1 January 2016 is agreed as the Solvency II implementation date. No quarterly submission is required at Q4 2015.

EIOPA has granted 2 extra weeks for completing the annual submission in 2015 (as at year end 2014). Therefore the deadline for submission is 22

weeks after year end for solo undertakings and 28 weeks for groups. The quarterly submission deadline is unchanged at 8 weeks.

*It is clear that EIOPA expects one annual submission prior to full Solvency II implementation. EIOPA has not addressed the requirement for a year end submission as at 31 December 2015.*

*However article 302bis of the draft implementing measures (circulated to stakeholders in October 2011) looks likely to require all firms to submit an opening Solvency II balance sheet as at 31 December 2015 (assuming a Solvency II start date of 1 January 2016) together with details of the SCR.*

EIOPA has introduced some further materiality thresholds and exemptions in the interests of proportionality. The calculation of technical provisions in Q3 2015 may rely on simplified methods in the calculation of the risk margin and the best estimate (to be further elaborated by EIOPA). Also captives have been exempted from the submission of information in Q3 2015.

A threshold of 90% now applies during the preparatory phase to the split of assets and liabilities by currency and to the split of technical provisions by country.

A new template named “Content of the submission” was added to the reporting package. This template is to be used to assess the completeness of the submission of information. The current draft of the template contains only the templates required and the options applicable for the preparatory phase.

A technical annex has been included setting out data checks which the data submitted should comply with. These checks relate to the subset of information for the preparatory phase only.

EIOPA addresses the specific issues raised by stakeholders under several headings including:

#### Changes to the templates

A final list and format of templates has been provided (with new naming conventions) including a log of changes from previous versions, for the templates applicable in the preparatory phase.

Many of the changes to the templates are correcting errors but changes have also been made to add

cells regarding information on Ring-Fenced Funds and to modify the SCR templates.

In Annex I EIOPA sets out the data items to be submitted in the preparatory phase. Annex II contains a list and description of each item required in the preparatory phase templates.

*EIOPA states that the templates and cells not covered by the preparatory phase will be renamed during EIOPA's development of the technical standard.*

*The absence of a complete package of templates in Excel format makes it difficult for undertakings to prepare completely for the submission of information requirements.*

### **XBRL**

EIOPA will make a tool available for undertakings to submit information using XBRL in time for the preparatory phase.

### **ECB**

The European Central Bank ("**ECB**") is also planning to collect additional data from the insurance industry for the purposes of market monitoring and financial stability analysis. EIOPA has been coordinating with the ECB to ensure that the reporting package proposed by the guidelines is sufficient to meet ECB's expected initial requirements. EIOPA will continue to engage in a dialogue with the ECB aiming to avoid undue costs to undertakings arising from different requirements.

*A letter from the Central Bank of Ireland ("**CBI**") to Irish insurance companies on ECB data requirements stated that the ECB will issue a regulation in 2014 and the CBI will commence collecting data in Q3 2015, even in the case of further delays to the Solvency II Directive.*

### **Third country branches**

EIOPA clarified that third country branches operating in the EU are excluded from the submission of information requirements during the preparatory phase and should also therefore be excluded from the market share calculations.

### **Thresholds on market share**

EIOPA confirms that in cases where undertakings fall below thresholds on individual level, they should

be reported on group level when they are part of a group which is subject to reporting under the preparatory guidelines.

EIOPA has provided further clarification with respect to the market share calculation. The methodology for identification of undertakings covered by the market share has also been amended.

*The CBI is using PRISM ratings to determine whether Irish insurance undertakings are within scope or not for the submission of information requirements (and the extra assessments under the FLAOR). Therefore the change to the threshold methodology does not impact Irish undertakings.*

*We currently believe undertakings that are rated High or Medium-High under PRISM are in scope for the preparatory requirements.*

*However undertakings that are rated Low or Medium-Low will still be required to submit information if they are part of a group which is in scope.*

### **Deduction and Aggregation method**

EIOPA clarifies that for the purpose of the preparatory phase all third countries are considered to be equivalent when the deduction and aggregation method is applied.

EIOPA states that the default method for calculation of the group SCR is the accounting consolidation method.

However EIOPA has stated that during the preparatory phase, a group can decide which method it wishes to apply with regard to third country undertakings. This can be irrespective of the decision of the group supervisor on the calculation method once Solvency II applies. Where the group does not exclusively apply the accounting consolidation method, the rationale should be explained to the group supervisor.

### **Standard formula SCR templates for Internal model companies**

EIOPA highlights that undertakings planning to use an internal model should submit information on the SCR calculated both with the standard formula and with the full/partial internal model. (This is also mentioned in the FLAOR guidelines and the internal model guidelines.) The standard formula

information required is covered under the pre-application for internal model guidelines (see below) and not under the submission of information.

### **Narrative reporting**

EIOPA amended the guidelines in order for NCAs to receive the narrative report in electronically readable format.

### **SYSTEM OF GOVERNANCE**

The 57 system of governance guidelines in the draft consultation have been reduced to 52 guidelines which are grouped in the following themes:

- General Provisions for preparatory Guidelines (Guidelines 1-2)
- System of Governance relating to:
  - General Governance Requirements (Guidelines 3-10)
  - Fit and Proper (Guidelines 11-14)
  - Risk Management (Guidelines 15-24)
  - Prudent Person (Investment Management) (Guidelines 25-30)
  - Own Funds Requirements (Guidelines 31-32)
  - Internal Controls (Guidelines 33-34)
  - Internal Audit Function (Guidelines 35-37)
  - Actuarial Function (Guidelines 38-43)
  - Outsourcing (Guidelines 44-57)
- Group Governance Specific Requirements (Guidelines 48-52)

The number of actuarial function guidelines has been reduced since the draft consultation guidelines. The valuation models of technical provisions guideline has been removed where the actuarial function was required to ensure that key risk drivers are reflected in the valuation model and that the models are stable. The testing against experience guideline has also been removed where the actuarial function was required to report any material deviations of experience against the projected best estimate to the AMSB.

The number of internal audit function guidelines has also been reduced but most of the previous content remains, it has just been re-structured slightly.

The final guideline in the draft consultation guidelines on group internal models has also been removed (this requirement is covered under the internal model guidelines).

There are also several wording changes to the guidelines but these are mostly for clarification rather than reflecting any change to the guidelines.

EIOPA addresses the specific issues raised by stakeholders under several headings including:

### **Fit & proper requirements**

In relation to outsourcing, EIOPA states that the fit and proper requirements for key functions apply regardless of whether the key function is performed by employees of the undertaking or is outsourced to a service provider. EIOPA also states that it is not sufficient to rely on the contract with the service provider to ensure that requirements are met.

### **Key functions**

EIOPA agrees that for key functions other than the internal audit function smaller and less complex undertakings could be allowed to allocate more than one key function to one person (with any possible conflicts of interest addressed accordingly).

### **Risk management**

The following requirement was removed from the contents of the risk management policy in relation to risk mitigation techniques (even though in EIOPA's resolution of comments it states that it will retain it):

"Procedures for ensuring that unit-linked policyholders continue to receive benefits in line with aims and objectives originally communicated to them."

### **Prudent person principle**

A major criticism from stakeholders was in relation to the requirement for undertakings to develop a set of key risk indicators for investments and not to solely depend on the information provided by other financial institutions, asset managers and rating agencies.

EIOPA states that undertakings should develop an approach that is proportionate taking into account the risks in their investments.

### **Internal audit policy**

EIOPA has clarified that both whistle-blowing to the NCA and staff rotation should be considered for establishing the internal audit policy, bearing in mind proportionality, but that the requirements are not intended to be mandatory.

### **Outsourcing of underwriting**

EIOPA clarifies that activities captured by the Insurance Mediation Directive can still fall under the outsourcing requirements where these activities

meet the definition of outsourcing. Underwriting falls under this definition if the person mandated with the underwriting is not an employee and makes the final decision about the underwriting.

### Scope of outsourcing

The following item was added to the contents for the outsourcing written policy:

“The criteria for determining whether a function or activity is critical or important.”

### Group specifics

EIOPA states that the role and responsibilities of the AMSB and the key functions of an undertaking are not diminished because this undertaking is part of a group.

However the group AMSB must be able to challenge the decisions of the AMSB of a related undertaking when these decisions have a material impact on the group.

EIOPA states that a key function of a group could also serve as a key function of an undertaking of a group and vice versa.

## PRE-APPLICATION FOR INTERNAL MODELS

The 72 internal model guidelines in the draft consultation have been reduced to 70 guidelines which are grouped in the following themes:

- General Provisions for Guidelines (Guidelines 1-2)
- Pre-application for internal models (Guidelines 3-4)
- Model changes (Guidelines 5-8)
- Use Test (Guidelines 9-17)
- Assumption setting and expert judgement (Guidelines 18-22)
- Methodological consistency (Guidelines 23-25)
- Probability distribution forecast (Guidelines 26-29)
- Calibration - approximations (Guidelines 30-35)
- Profit and loss attribution (Guidelines 36-38)
- Validation (Guidelines 39-50)
- Documentation (Guidelines 51-57)
- External models and data (Guidelines 58-65)
- Functioning of colleges during the pre-application process for internal models for groups (Guidelines 66-70)

Several wording changes have been made to the guidelines to provide clarity. In addition the following items have been removed and added.

### Items removed

One of the guidelines under the use test on support of decision-making has been removed. This required documentation of the use of the internal model in decision making and that regular internal model results were received by the AMSB.

The guideline on the application of profit and loss attribution and the use test has also been removed. This required documentation of how the results of the profit and loss attribution might be used within risk management and decision making.

Under guideline 42 (previously guideline 44) an item has been removed under the quality of the validation process. This item had required undertakings to identify the source of uncertainty related to the validation process and quantify the degree of uncertainty, if feasible.

An item has been removed under guideline 68 (formerly guideline 70) on joint on-site examinations stating that the NCA should also inform the undertaking of the outcome of the joint on-site examination.

### Items added

A new item has been added under guideline 3 requiring the standard formula SCR to be submitted to the NCA. It states that the information to be submitted should cover the overall SCR and the following risk categories, for the risks within the scope of the internal model:

- Market risk
- Counterparty default risk
- Life underwriting risk
- Health underwriting risk
- Non-life underwriting risk
- Non - life catastrophe risk
- Operational risk

The information to be submitted should be agreed by NCAs to the most granular level they deem appropriate and should take account of the items defined in the submission of information guidelines.

The submission of this information should follow the reference dates and deadlines agreed by the NCAs with the undertaking during the pre-application process.

A new item has been added under guideline 53 on circumstances under which the internal model does not work effectively. This requires documentation on the material shortcomings of the internal model to include “the work done to identify these shortcomings and any plans for model improvements”.

A new item under guideline on tasks of the group supervisor states that the group supervisor and the other NCAs concerned “should consider including in the work plan specific provisions which set up the allocation of tasks and communication rules between them”.

## SUMMARY

Undertakings are now under pressure to ensure they can comply with the preparatory guidelines from 1 January 2014.

For Irish insurance undertakings that are rated High or Medium-High under the CBI’s PRISM framework the timelines are expected to be as follows:

### 2014:

- Perform and submit a FLAOR (assessment of solvency needs only)
- All system of governance requirements in place

### 2015:

- Perform and submit a FLAOR (assessment of solvency needs, assessment on a continuous basis and assessment of deviation from SCR assumptions all required)
- Submit annual templates within 22 weeks of YE 2014 and quarterly templates within 8 weeks of Q3 2015

The timelines for undertakings rated Low or Medium-Low are as follows:

### 2014:

- Perform and submit a FLAOR (assessment of solvency needs only using CBI reporting tool)
- General system of governance requirements in place

### 2015:

- Perform and submit a FLAOR (assessment of solvency needs only using CBI reporting tool)
- Key functions established and associated system of governance requirements in place

Note that undertakings rated Low or Medium-Low that are part of a group that is in scope will also be required to submit information at Q3 2015 and YE 2014.

Final guidelines from the CBI are expected in November 2013.

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