EIOPA Consultation Paper on proposals for Solvency II 2020 review

Package on Supervisory Reporting and Public Disclosure – Solvency and Financial Condition Report

This is one of five briefing notes that Milliman has produced summarising the consultation papers produced by EIOPA in June 2019 in relation to the Solvency II 2020 review. EIOPA has requested stakeholders to provide feedback on these papers by 18 October 2019.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

As part of the 2020 Review, EIOPA has been asked to assess the current supervisory reporting and public disclosure requirements. On 19 December 2018, EIOPA issued a Call for Input[2] to provide the opportunity for the industry and other stakeholders to give input on areas that could be further improved regarding Solvency II reporting and disclosure.

Taking into consideration the responses and feedback from stakeholders, on 25 June 2019 EIOPA published a Consultation Paper (the **CP**) on its proposals for the 2020 Review regarding supervisory reporting and public disclosure. EIOPA has included a summary of the feedback it received from various stakeholders in the CP.

The consultation comprises four separate papers[3] looking at:

- General issues on supervisory reporting and public disclosure
- Individual Quantitative Reporting Templates (**QRTs**) for the submission of information to the supervisory authorities and supporting annexes with additional details on proposed changes;
- Solvency and Financial Condition Report (**SFCR**) and Narrative Supervisory Reporting; and
- Financial Stability Reporting

This summary focuses on one of these documents in which EIOPA presented its proposals regarding the SFCR and narrative supervisory reporting.

The main areas that EIOPA addressed in the CP in relation to the SFCR were the:

- Addressees of the SFCR;
- Structure and content of the SFCR;
- Gaps identified in the SFCR information;
- Availability of the SFCR;
- Audit of the SFCR; and
- Actuarial Function Report.

We provide more detail on some of the main areas of the CP in this briefing note.

EIOPA also presented proposals in relation to the language requirements of the SFCR, and the QRTs presented in the SFCR. These areas are discussed in this briefing note in relation to the structure and content of the SFCR, and/or the gaps identified in the SFCR where relevant.

It should be noted that a number of these areas were first considered by EIOPA in a Supervisory Statement in late 2017[4] (the **2017 SS**), where it considered the findings and areas for improvement for the SFCR following the first set of published SFCR.

EIOPA has requested stakeholders to provide their feedback on the proposals set out in the CP by **18 October 2019**. The result of this consultation will be included in an EIOPA Opinion to be submitted to the EC by June 2020. After this date, some of the proposals will need to be considered by the EC and will eventually be reflected in the Level 1 Directive and/or Level 2 Delegated Regulation amendments, or in Implementing Technical Standards (**ITS**) without any legislative amendment. The actual implementation date for changes to the Solvency II rules following the 2020 Review remains unclear.

In the remainder of this briefing note, we provide more detail on some of the most material changes that are proposed for the SFCR.

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive
[2] Call for input on the Solvency II reporting and disclosure review 2020
[3] EIOPA consultation on supervisory reporting and disclosure
[4] EIOPA's Supervisory Statement; Solvency II: Solvency and Financial Condition Report

Addressees of the SFCR

A criticism of the SFCR in its current form is that it has been failing to adequately meet the needs of any stakeholder group. It is seen by some as too long and technical for policyholders, who prefer information presented in more readable documents, and too light on valuable quantitative information for some professional readers, who are relying on this document given the decline in popularity of other disclosures, such as embedded value.

Consequently, EIOPA proposes to split the SFCR into two distinct sections; any part of the SFCR that is directed at, or to be used by policyholders (the **policyholder section**) should be clearly separated out from any parts of the SFCR addressed to more technical users (e.g. analysts, rating agencies and investors) (the **non-policyholder section**).

Importantly EIOPA proposes that the policyholder section of the SFCR is only required by undertakings that have external policyholders. This would exclude captive insurers or reinsurance undertakings from this requirement.

The policyholder section of the SFCR should adhere to the following:

- The information should be simple, concise, objective, balanced and non-promotional. No information at a group level should be provided.
- The information should be accessible, and so should be on the website of the undertaking, in the same place, each year. It should also stay on the website for five years.
- The information should also be available in the local language of the respective Member State (and translated upon request in the case of freedom of services/ freedom of establishment arrangements).
- EIOPA will provide standardised text and tables for certain areas of interest to policyholders, such as information on the security of benefits (i.e. the Minimum Capital Requirement (**MCR**) and Solvency Capital Requirement (**SCR**) coverage ratios).

The key areas of information to be included in the policyholder section are:

BUSINESS AND PERFORMANCE

- Standard information, such as on the name of the undertaking and of any group of which it is part.
- Significant business or other events that occurred over the reporting period, that have or may yet have a material impact on the risk profile of the undertaking. This could include important mergers and acquisitions, for example.
- Quantitative information on the undertaking's investment and aggregated underwriting performance by material lines of business. This must include important items such as premiums, claims, investment return and profit and loss.
- A statement on the consideration of environmental, social and governance (**ESG**) factors in the investment policy of the undertaking.

SYSTEM OF GOVERNANCE

In addition to any relevant information on the system of governance that is currently included in the SFCR, EIOPA proposes that there should also be a description of the outsourcing policy of the undertaking, whenever the outsourcing of any critical or important operational functions directly affects policyholders. This includes claims management, but excludes sales or distribution.

The descriptions must include information on the local jurisdiction of the service providers of such functions or activities.

RISK PROFILE AND CAPITAL MANAGEMENT

There should be a section describing the current risk profile of the undertaking, which includes changes in these risks over the reporting period, and an explanation of any risk mitigation techniques in place.

In addition, EIOPA will provide standardised text for all undertakings to include in the policyholder section explaining the purpose of the SCR, the calculation of the SCR (i.e. standard formula and internal model calculation), the purpose of the MCR, and eligible own funds (**EOF**).

Undertakings have also been asked to include information on:

- Whether the SCR is calculated with the standard formula, or an internal model (partial or full).
- The ratio of the SCR and MCR coverage at the end of the reporting period, and the previous reporting period (allowing for long-term guarantee measures). There should also be details of any non-compliance with either the SCR or MCR.

Given that the policyholder section is set to streamline and focus on areas of key importance to policyholders, such as the security of policyholder benefits, the governance (in particular outsourcing) applicable to policies, and the profile of risks that the policies are exposed to, we anticipate that this proposal could make the document more relevant amongst this key stakeholder group.

Provided the text is sufficiently non-technical, the use of standardised text in areas regarding risk and capital management could better help policyholders understand the technical concepts introduced in the SFCR. This should help policyholders to be sufficiently informed on how the profile of risks facing a company are quantified, and changing over time, enabling them to make more informed decisions regarding the risks they wish to be exposed to.

Some of the changes proposed may require companies to begin planning well in advance of the implementation date following the 2020 Review. For example, reporting on the ESG factors in the investment policy may be an area some companies do not report on at present, or are currently developing.

Structure and content of the SFCR

Regarding the new non-policyholder section of the SFCR addressing the users other than policyholders, seen as a technical or professional audience (e.g. investors, credit rating agencies and analysts) EIOPA has proposed the following amendments:

- The structure will be streamlined into four areas rather than five: business and performance, system of governance, valuation for solvency purposes, and risk and capital management. The current section on risk profile will combine with capital management to form one section.
- Move some content of the SFCR to the Regular Supervisory Report (**RSR**): in particular detailed information on the system of governance and capital management policies of the undertaking.
- Regulation must be updated to provide clarity on what constitutes a "major development" that would require the SFCR to be corrected and re-published.

In addition, EIOPA proposes to publish either guidelines, supervisory statements or other tools in order to strengthen the principles outlined below:

- No information included that is not explicitly required, as well as no repetition of the legal requirements of Solvency II or of accounting standards;
- Information should be undertaking specific;
- Readability and comparability could be improved through more structured formats e.g. using graphs or tables. Examples of good practice could be collected; and,
- If information is non-applicable, it should be explicitly stated.

EIOPA has also proposed that there should be no change to the templates that are included in the SFCR. The exception to this will be cases where additional, new information will be presented in templates (i.e. to address any gaps identified in the SFCR, as covered in the next part of the memo, such as additional SCR sensitivities and Own Funds variation over the year).

These changes as a whole aim to create a more streamlined, focused document for professional readers, allowing them improved readability and greater comparability across firms.

In our experience, some SFCRs have become very long documents, with the narrative sections padded with generic text, and the content and quality varies greatly amongst companies. The guidance set out in EIOPA's proposal may benefit both readers, and those responsible for producing the SFCR.

Finally, respondents to the Call for Input stated that the current language requirements for the SFCR are costly and labour-intensive for groups with numerous subsidiaries in a range of Member States to implement. Furthermore, investors, analyst and rating agencies would prefer the report to be published in English. In response, EIOPA has set no requirement to translate the non-policyholder section of the SFCR into the language of the Member State.

Although EIOPA's proposal does not remove the need for the SFCR to be translated altogether, the industry may respond positively to the requirement being restricted to the policyholder section of the report, and not also the non-policyholder section.

Gaps identified in the SFCR information

As part of the CP, EIOPA has looked to identify any potential gaps in the information currently contained within the SFCRs. EIOPA requested input from the industry prior to this CP, via the Call for Input, and based on the responses received has come up with two areas that it considers could be included in the SFCRs going forward. These areas are set out below.

SENSITIVITIES

A key gap identified in the SFCRs was the lack of comparability between the information on the sensitivity of the SCR (and other key metrics). This particular gap was previously identified by EIOPA in the 2017 SS.

To bridge this gap, EIOPA proposes to introduce a set of standardised sensitivities that would be disclosed as part of the reports. The information produced would need to show the impact of the sensitivity on the SCR and on the amount of Own Funds. The sensitivities proposed are:

- **Economic Assumptions:**
  - Equity markets (+/-25%);
  - Interest rates (+/-50bps);
  - Credit spreads of government bonds (+/-50bps);
  - Credit spreads of corporate bonds (+/-50bps); and,
  - Real estate values (+/-25%)
- **Non-economic Assumptions:**
  - Expenses (+10%);
  - Gross loss ratio (+10%); and,
  - Lapse rates (+10%).

Companies may continue to publish a set of sensitivities that they believe better reflect risk profile with reasons behind why they feel these are more appropriate. However, these would be published in addition to the proposed standardised sensitivities.

There is still an open question from EIOPA as to whether this should be included as a template at the end of the report, or as a table in the relevant part of the SFCR.

Some of the suggested sensitivities are similar or even identical to those published in the European CFO Forum Market Consistent Embedded Value Principles© (**the MCEV**

Principles[5]). There are however no stresses that refer to mortality rates, morbidity rates or the volatility of assets like there are under the MCEV Principles.

VARIATION OF OWN FUNDS

The second key gap in the SFCRs that was identified is the movements in Own Funds over the reporting period. Primarily, the purpose of this would be to help identify the drivers of changes in Own Funds.

EIOPA proposes to require the disclosure of a series of movements in the amount of Own Funds both as percentage of the Own Funds and as an absolute value. The series of movements that would need to be disclosed are:

- Amount of Own Funds at the beginning of the period;
- Changes due to valuation of the assets;
- Changes due to new capital issued or redeemed;
- Changes due to valuation of technical provisions of existing business;
- Changes due to new business;
- Changes due to taxation;
- Changes due to dividends (foreseeable and paid);
- Changes due to other items; and,
- Amount of Own Funds at the end of the period.

If the changes due to other items were to represent more than 20% of the movement over the period, the company would need to provide further details on the drivers of this movement.

This additional quantitative information may result in additional QRTs and/or narrative information on SCR sensitivities and Own Funds variations over the year.

The proposal for the SFCR to contain additional quantitative information should be received positively by analysts that, given the decline in embedded value reporting, rely on SFCRs as the main source of financial information on insurance companies.

Many companies currently report some sensitivities as part of their SFCR, however which sensitivities they show are entirely at the discretion of the company. This means it is difficult to compare the sensitivity of companies to their assumptions and as such analysts and other consumers of the reports are likely to welcome a move to a standardised set.

The CP does not specify whether the sensitivities outlined above would be shown before or after the impact of any management actions[6], with the prior potentially being of more use for analysts in understanding the underlying risk exposures.

EIOPA's proposal to include information on the variation of Own Funds shares similarities to the steps proposed by the Prudential Regulation Authority (**PRA**), the national competent authority (**NCA**) in the UK**,** in a September 2018 speech[7]. However the PRA's steps are greater in number as they consider movements in the Risk Margin, Transitional Measure on Technical Provisions (**TMTP**) and SCR individually for each change. There is also an element of looking at actual versus expected new business.

For life insurance firms, the steps are also comparable to those outlined as part of the MCEV Principles, however these break down some of the above categories such as 'changes due to valuation of technical provisions of existing business' into multiple steps, while also consolidating the steps referring to dividends, tax and other changes into one final closing adjustments step.

Availability of the SFCR

In the 2017 SS, EIOPA identified that although the majority of SFCRs were easy to find, this is not the case for all. As a result of this, EIOPA has drafted a proposal to improve the publication requirements on firms. This proposal contains three changes to the requirements.

1. SFCRs should be able to be found on the company website, each year, in the same location. The reports should remain available on the website for five years.
2. Within the section addressed to policyholders the SFCR should:
   - Include a disclaimer that the second section of the SFCR contains more detailed information, with a link to the section; and,
   - Links to other available policyholder information should be provided in the area of the website. Links to the SFCR area of the website should be provided in other relevant parts of the company website.
3. The SFCR should be in a format that is machine-readable. This will be discussed further in a future wave of the 2020 Review.

EIOPA is discussing with its NCAs the best ways to create national or European-wide sources for the SFCRs. Options include providing links to all available SFCRs, creation of a repository of the SFCRs or publication of the data already disclosed in the reports. Some countries, such as Ireland and the Netherlands, already publish consolidated information based on the SFCRs of companies within those countries.

In practice, the SFCRs for some companies remain challenging to find and tighter rules regarding their availability will help these to be easier to locate in the future.

[5] Copyright© Stichting CFO Forum Foundation 2008. CFO Forum; Market Consistent Embedded Value Principles

[6] Future management actions (e.g. the use of risk-mitigation techniques) in response to specific circumstances (often stressed conditions) can sometimes be embedded in actuarial models when calculating the technical provisions.

[7] A 'D to Z' of current issues in Insurance Supervision – Speech given by David Rule

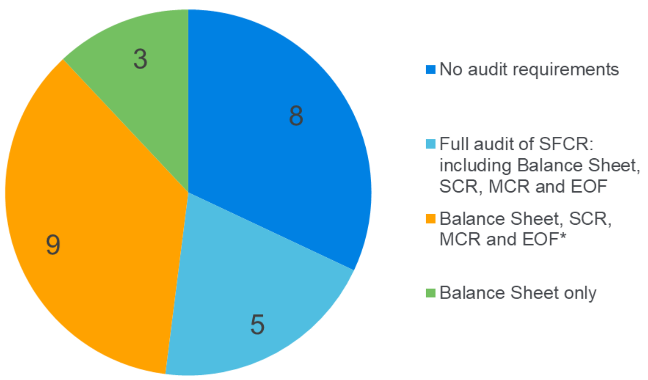
EIOPA's proposal for the SFCR to be in a machine-readable format for the SFCR could be helpful for analysts tasked with collating and analysing the quantitative and qualitative elements of the SFCRs of many companies.

External audit of the SFCR

The Solvency II Directive does not currently require an external audit of any of the quantitative information presented in the SFCR.

This has resulted in a divergence in practice across Europe, as shown in Figure 1. A number of Member States have introduced full or partial external audit requirements for the SFCR. For example, in the UK the balance sheet, SCR[8], MCR and EOF are subject to audit, with smaller undertakings being exempt from the audit requirement.

FIGURE 1: A SUMMARY OF THE CURRENT AUDIT REQUIREMENTS ACROSS MEMBER STATES



(*) Includes the UK where the audit scope excludes the SCR for (partial) internal model firms, sectoral information, and where smaller firms are out of scope. Includes Ireland and Slovenia where an audit of certain qualitative information is also required in addition to the quantitative information.

The consideration of whether the Solvency II Directive should include an external audit requirement is not new - EIOPA first considered this in 2015 and at that time published a note[9] highlighting the need for high quality public disclosure standards.

Three years on from the start of the Solvency II regime EIOPA believes that sufficient industry experience has emerged to adequately review the benefits and drawbacks of audit requirements.

In response to the Call for Input to the CP, EIOPA received diverse feedback from different stakeholders, owing to the interests and priorities of that group. In particular, consumer protection bodies, external auditors and NCAs were all in favour of an external audit requirement, arguing that it would improve the accuracy and quality of information provided in the SFCR. In contrast, certain insurance undertakings provided feedback that the current external audit requirements (that apply in certain Member States) were too costly and had burdensome time constraints, with little evidence of an improvement in the quality of the reports. However, all stakeholder groups were in favour of a harmonised approach to external audit requirements across Europe.

In response to these views, EIOPA considered three options regarding the audit of the information presented in the SFCR:

1. **Option 1:** No change – keep the legislation as it is, with no audit requirement in the Solvency II Directive (the NCA of a Member State can determine if they want to impose an external audit a requirement);
2. **Option 2:** Minimum requirement explicitly stated in the Solvency II Directive on the audit of the Solvency II balance sheet (the NCA of a Member State can determine if they want to impose additional requirements); and,
3. **Option 3**: Minimum requirement explicitly stated in the Solvency II Directive on the audit of the Solvency II balance sheet, SCR[10], MCR and EOF (with members discretion to impose additional requirements).

To ensure a minimum level playing field, improve transparency, and to provide a higher quality of disclosed information, whilst ensuring the additional regulatory costs are proportionate to the additional benefits, EIOPA proposes that Option 2 is implemented.

HARMONISING AUDIT REQUIREMENTS ACROSS EUROPE

One of the objectives of Solvency II is to harmonise the approach to supervision of European insurers, and EIOPA's proposal aims to align the requirements for obtaining independent assurance from auditors for public disclosure.

As shown in Figure 1, currently eight Member States[11] do not have a requirement for the Solvency II balance sheet to be audited, and so will need to transpose the new rules into their national law if Option 2 is implemented.

However, the current audit requirements of fourteen Member States[12] are in excess of EIOPA's current proposal; EIOPA's proposal to allow the NCA of a Member State to set an additional auditing requirement, for example to cover the MCR, SCR and EOF, is likely to see these Member States

[8] (Partial) internal model firms are not required to have an external audit of the SCR.
[9] Need for high quality public disclosure: Solvency II's report on solvency and financial condition and the potential role of external audit.
[10] The CP does not make it clear whether the SCR of (partial) internal model firms would be in scope of the audit requirements.

[11] Slovakia, France, Hungary, Latvia, Finland, Czech Republic, Estonia and Lithuania
[12] Austria, Belgium, Italy, Netherlands, Poland, Portugal, Slovenia, Spain, Sweden, Malta, Croatia, Romania, Ireland, and the UK.

retaining the additional audit requirements they currently have in place.

Consequently, although the proposal will result in greater alignment across Europe, some inconsistency in the audit requirements may remain. This may continue to frustrate those who argue that any inconsistency in audit requirements results in reduced comparability of SFCRs across Europe, additional complexity for multinationals and potential barriers to entry to operating in Member States with more stringent audit requirements.

SMALLER COMPANIES AND THE PROPORTIONALITY PRINCIPLE

Smaller companies will not be exempt from the new audit requirement. Consequently, in Member States where there is currently audit exemptions for smaller companies (for example in the UK) an audit of the balance sheet will now be required.

The view of EIOPA, presented in this CP, is that auditing is key to transparency and accuracy of information, and that these principles should not be subject to the proportionality principle.

EIOPA's view on the proportionality principle in relation to smaller firms therefore directly opposes the view of those NCA's that have, to date, chosen to exempt smaller firms.

For example, in the UK where there is a requirement for certain elements of the SFCR to be audited[13], the PRA removed this requirement for smaller companies for financial reporting after November 2018, following a consultation in 2018[14]. The PRA based its decision on the fact that for smaller firms:

- The actual audit costs incurred were higher than the PRA had expected; and
- Following two years of the Solvency II regime the benefits of the audit requirement (e.g. comfort over the implementation of Solvency II, setting up SFCR processes, production of higher quality SFCRs) would have been largely realised.

In light of this, the PRA argued in its consultation paper, CP8/18[15], that the cost was disproportionate to the benefit for smaller firms.

EIOPA states in the CP that it believes that smaller companies are, by nature, less complex and so will have a simpler, and thus cheaper audit, of which the PRA consultation did not see evidence.

EIOPA may still change its mind; in the CP EIOPA requests input from stakeholders that are currently subject to an audit of the Solvency II balance sheet on the audit costs in relation to year-end 2018, in relation to gross written premiums. If the result of this analysis echoes that of the earlier UK-focused PRA research, EIOPA may consider excluding smaller firms from the audit requirement.

RELAXED AUDIT TIME CONSTRAINTS

As a result of the introduction of this audit requirement, EIOPA proposes an extension of the annual reporting and disclosure period by two weeks - a direct response to the views presented by insurance undertakings in the consultation.

Actuarial Function Report

The Solvency II Directive requires the Actuarial Function of an insurance company to produce and submit a written report to the administrative, management or supervisory body of that company at least annually. Currently, many NCAs request the report to be submitted to them on a regular basis, with others requesting this on an ad-hoc basis.

EIOPA considered whether changes should be made to the Level 2 Delegated Regulation to include the report as a regular report to be submitted in a machine compatible format, or whether to keep the report as an internal document.

Although EIOPA considers that the report is of key importance in assessing the adequacy of the technical provisions, EIOPA proposes to continue to keep the Actuarial Function Report as an internal document, and not make it subject to standardisation of its structure (such as that required to put the report into a machine readable format).

Summary

The recommendations proposed by EIOPA in this CP are intended to ensure the SFCR remains fit-for-purpose by all stakeholders that use the document. Some of the highlights from the CP in relation to the SFCR are:

- To take into account the needs of different stakeholders, and the different levels of expertise of professional and non-professional readers, EIOPA proposes to split the SFCR into two sections, that are addressed to:
  - **Policyholders** – this section must be short, limited in scope and easy to read, focusing on areas of Solvency II that are relevant to policyholders; and
  - **Non-policyholders** – this section should broadly follow the current form of the SFCR and should target professional readers only. It should contain less information than currently provided in some areas, and more detailed, structured, harmonised information in others.
- In the section addressed to professionals, EIOPA proposes changes to require more complete quantitative information in the SFCR, potentially resulting in additional QRTs and/or narrative information on sensitivities and Own Funds variations over the year.

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[13] The balance sheet, SCR, MCR and EOF. (Partial) internal model firms are not required to get the SCR audited.

[14] Solvency II: external audit of the public disclosure requirement

[15] CP8/18 – Solvency II: external audit of the public disclosure requirement

- EIOPA proposes changes to the external audit requirements of the SFCR, such that as a minimum the Solvency II balance sheet is subject to external auditing by a qualified auditor.
- EIOPA proposes that the SFCR is to be presented in a machine readable format, and is considering options that would allow easy public access to all published SFCRs (e.g. creating a centralised repository).

In the CP, also EIOPA presents two questions to stakeholders, encouraging them to provide feedback to them by 18 October 2019.

Firstly, EIOPA requests the views of stakeholders on whether the additional sensitivities and analysis of change of Own Funds, described in 'Gaps identified in the SFCR information' be presented in a new template in the QRTs (to assist readability and comparability), or in a table in the risk profile and capital management section of the SFCR (to ensure the necessary narrative information is included alongside the quantitative information).

Secondly, EIOPA requests that all stakeholders that already audit the Solvency II balance sheet to provide EIOPA with information on the audit costs[16] using amounts as at year-end 2018.

[16] Preferably as a percentage of gross written premium.

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