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IMPACT ASSESSMENT REPORT

Accompanying the documents

Proposal for a Directive of the European Parliament and of the Council

amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision
and
Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of insurance and reinsurance undertakings and amending Directives 2002/47/EC, 2004/25/EC, 2009/138/EC, (EU) 2017/1132 and Regulations (EU) No 1094/2010 and (EU) No 648/2012

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Glossary

Term or acronym	*Meaning or definition*
CMU	Capital Markets Union
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ESRB	European Systemic Risk Board
EU	European Union
FoE / FoS	Freedom of establishment / Freedom of services
DG FISMA	Directorate General for Financial Stability, Financial Services and Capital Markets Union
FSB	Financial Stability Board
GWP / GDWP	Gross written premiums / ¨Gross direct written premiums
Home authority	National Supervisory authority which granted licensing to an insurer
Home Member State	Member State where an insurance or reinsurance company obtained its license
Host authorities	National supervisory authorities other than the Home authority of the Member States where an insurance or reinsurance company is operating
Host Member State	Member States other than the Home Member State where an insurance or reinsurance company is operating
IAIG(s)	Internationally Active Insurance Group(s)
IAIS	International Association of Insurance Supervisors
IGS(s)	Insurance Guarantee Scheme(s)
Insurance / Insurer	Unless otherwise specified, the use of the term insurance refers to both insurance and reinsurance activities
MCR	Minimum Capital Requirement
NCA / NCAs	National Competent Authority / National Competent Authorities
NSA / NSAs	National Supervisory Authority / National Supervisory Authorities
ORSA	Own risk and solvency assessment
RSR(s)	Regular supervisory report(s)
SCR	Solvency capital requirement
SFCR(s)	Solvency and financial condition report(s)
Solvency ratio	Ratio of capital resources to solvency capital requirement
VA	Volatility adjustment

The three “pillars” of Solvency II

Solvency II constitutes a three-pillar framework (capital requirements, governance, transparency), **which is risk-based and market-based**.

The “Pillar 1” sets out quantitative requirements, including the market-based rules to value assets and liabilities, the general design of capital requirements. The capital requirements are risk-based, forward-looking and economic, i.e. tailored to the specific risks borne by each insurer and taking into account risk diversification benefits, allowing an optimal allocation of capital across the EU.

The framework is designed in such a way that an insurer complying with its requirements is supposed to be able to cope with an extreme adverse event, whose probability of occurrence is only 1 in every 200 years. In other words, the insurer is then supposed to be able to meet its obligations to policyholders and beneficiaries over the 12 following months, with a 99.5% probability. Hence, where the insurer complies with these risk management rules, the risk of an insurance failure over the following year should reach a very low probability (even though not null).

The “Pillar 2” consists of requirements for the governance and risk management of insurers, as well as the details of the effective supervisory process with competent authorities. A key Pillar 2 requirement is the “own risk and solvency assessment” (ORSA). It aims at supporting insurers to get a holistic view of its risk profile and understand how risks affect the future solvency situation. It requires that the insurer undertakes its own “stress testing”, integrating all foreseeable risks such as a volatile and uncertain economic outlook. It also implies that insurers, when defining their own “risk appetite”, may (shall) look beyond the “purely quantitative” solvency requirements, and set level of “reserve”/available capital that are also forward-looking, as an additional cushion beyond the minimum regulatory quantitative requirements.

Finally, **the “Pillar 3”** focuses on reporting to supervisory authorities and disclosure to the public, thereby enhancing market discipline and increasing comparability.

1. INTRODUCTION

1.1. Political and legal context

The economic and social importance of insurance is such that intervention by public authorities, in the form of prudential supervision, is generally accepted to be necessary. Not only do insurers provide protection against future events that may result in a loss, they also channel household savings into the financial markets and into the real economy. With trillions of assets under management, the insurance sector remains a mainstay of the European financial industry.

The rationale for EU insurance legislation[1] is to facilitate the development of a Single Market in insurance services, whilst at the same time securing an adequate level of consumer protection.

The Directive on the taking-up and pursuit of the business of insurance and reinsurance (Directive 2009/138/EC) is also known as the Solvency II Directive. The Solvency II Directive, as amended by the Omnibus II Directive (Directive 2014/51/EU), has entered into application in 2016. The supplementing Delegated Regulation (EU) 2015/35 was intended to further specify a range of aspects of the Solvency II Directive, with the aim to facilitate a consistent implementation throughout the European Union. Those two levels of legislation form the 'Solvency II framework', or regime. The Solvency II regime replaces fourteen existing directives commonly known as 'Solvency I'.

The European Commission has a legal mandate to conduct a comprehensive review of the pivotal components of the Solvency II Directive by the end of 2020. This review is an opportunity to draw the lessons learned from five years of implementation of the Solvency II framework, including in crisis situations such as the one triggered by the Covid-19 outbreak, and to take into account the feedback received from insurers, consumers and public authorities. In order to appropriately take stock of the potential shortcomings in prudential rules, which have been highlighted by the pandemic crisis, the timeline of the review had to be extended by six months.

Finally, the review of the framework needs to be coherent with the political priorities of the European Union. In particular, both the renewed Capital Markets Union (CMU) Action Plan and the communication on the European Green Deal explicitly refer to insurers as key institutional investors whose role will be instrumental to the so-called "re-equitisation" in the corporate sector and the greening of the European economy.

The European Parliament and the European Council also identify the Solvency II Review as a pivotal initiative to support the objectives of the CMU. The European Parliament's report on further development of the CMU of 16 September 2020 requests the Commission to assess, on the basis of an impact assessment, the potential benefits and prudential justification of adjusting capital requirements for investments in businesses, notably of small and medium-sized enterprises (SMEs) to ensure that capital requirements for insurers do not discourage long-term investments. The Council Conclusions of 2 December 2020 on the Commission's CMU Action Plan urges the Commission, to prioritise and to accelerate its work in parallel on strengthening the role of insurers as long term investors and assessing ways to incentivise long-term investments in corporates and particularly SMEs without endangering financial stability or investor protection and ensuring risk adequate regulatory treatment of long term investments.

[1] For the purpose of this impact assessment, and unless stated otherwise, the term "insurance" will refer to both "insurance" and reinsurance".

At this stage, the Commission is pursuing several initiatives to increase private financing of the transition to a carbon-neutral economy and to ensure that climate and environmental risks are managed by the financial system. Those initiatives, which are listed in Annex 9, will have a significant impact on the insurance sector.

Other horizontal EU political priorities are being tackled in parallel, without having yet identified the need for a legislative change. For instance, the recently adopted Digital Finance Strategy has defined the main priorities for the EU and these priorities are also relevant for insurers and reinsurers. In that context, the Commission invited the European Supervisory Authorities (ESas), including EIOPA, to provide technical advice on digital finance. If necessary, Commission services will propose targeted amendments to the financial services acquis, including the Solvency II framework (possibly via a cross-sectoral proposal).

Following a formal request for advice that was sent by the European Commission to the European Insurance and Occupational Pensions Authority (EIOPA) in February 2019, EIOPA conducted three technical consultations covering the 19 topics of the Solvency II review that were identified by the European Commission. It also conducted two data collection exercises in order to quantify the cumulative impact of all policy proposals. EIOPA's final Opinion on the Solvency II review, and the associated background analysis and holistic impact assessment, were published on 17 December 2020. The Commission services' impact assessment largely leverage on the technical work and analysis conducted by EIOPA.

1.2. High-level overview of the main issues that the Solvency II review will aim to address

Since 2016 when it entered into application, the Solvency II Directive has provided a harmonised and sound prudential framework for insurance and reinsurance companies in the EU, as evidenced in the Evaluation Annex. Based on the risk profile of individual firms, it promotes comparability, transparency and competitiveness. Solvency II has significantly enhanced the protection of policyholders and beneficiaries, by limiting the likelihood that their insurer fails. It has also provided strong incentives for insurers to better measure and manage their risks, and to improve their internal governance. Under the coordination of the European Insurance and Occupational Pensions Authority (EIOPA), Solvency II has also facilitated supervisory convergence within the Union and contributed to the integration of the Single Market for insurance services.

Also thanks to Solvency II, the European insurance industry remained robust overall. With average levels of capital resources that remain more than twice as high as what is required by the legislation, insurers' solvency position has so far proved to be sufficiently solid to weather the economic and financial consequences of the Covid-19 outbreak[2]. However, due to the high level of uncertainty in the economic and financial outlook, regulators and supervisors still have to closely monitor future market developments.

The primary objective of Solvency II is the protection of policyholders. Achieving this objective requires that insurance companies are subject to effective solvency requirements based on the actual risks they are facing ("risk-based" framework). The framework is defined in such a way that the risk of an insurance failure over the following year, even though not null, is of very low probability, as an insurer complying

[2] The reasons why insurers' solvency ratios are on average far above the 100% "regulatory target" are provided in Sub-section 6.1.1 of the Evaluation Annex.

with its requirements is supposed to be able to cope with an extreme adverse event whose probability of occurrence is only 1 in every 200 years. The framework also relies on full market-based valuation of insurers' assets and liabilities, which allows monitoring the impact of economic and financial conditions on insurers' solvency in real time and on an ongoing basis.

However, the market value and risk-based principles also raise some challenges.

First, with regard to market risks faced by insurers, the risk-based approach implies that the definition of capital requirements on investments only depends on the relative riskiness of each asset over a one-year time horizon. Therefore, prudential rules do not take into account the instrumental role of insurers in financing long-term sustainable growth in the Union and in the economic recovery in the aftermath of the Covid-19 crisis. Both the European Green Deal and the Capital Markets Union Action Plan make this observation.

While Solvency II is not the main driver of insurers' investments, the framework may still provide disincentives to invest in assets such as equity, as insurance firms have to set aside more capital when holding such assets whose prices are generally more volatile than fixed-income securities. In addition, current rules do not capture the lower long-term risk of environmentally sustainable ("green") activities/assets (all else equal). Hence, it should be explored whether barriers to long-term sustainable investments are unjustified and could be eliminated so as to facilitate insurers' contribution to the financing of long-term sustainable growth, while preserving an appropriate level of policyholder protection.

Second, in order to be effective in protecting policyholders, the framework needs to be regularly updated, so that it appropriately captures all risks that insurers are facing due to structural changes in financial markets. At this stage, Solvency II provisions and parameters may prove to be outdated, as they do not reflect key trends, such as the protracted low – and even negative – interest rates environment, and its consequences.

Finally, reliance on market values can generate high volatility in the solvency position of insurers. Such volatility may unduly foster procyclical behaviours and short-termism in their underwriting and investment activities, although insurers are supposedly "long-term oriented" by nature. In particular, it can provide disincentives to the supply of (life) insurance products with guarantees, which are still highly sought by EU citizens, in particular for their pensions.

In addition to the issues stemming from market valuation and risk-based rules, the review of Solvency II should aim to address other challenges.

Solvency II is a highly sophisticated framework, which provides strong incentives for robust risk management by insurers. However, the framework can prove to be very complex, and its implementation generates significant compliance costs, in particular for smaller insurers. Solvency II embeds an overarching principle of proportionality, which supposedly ensures that both the requirements imposed to companies and the intensity of supervisory activities by public authorities are commensurate to the "nature, scale and complexity" of the risks of each firm. However, in practice, this overarching principle is abstract and results in legal uncertainties and insufficient visibility for both national supervisory authorities (NSAs) and companies, as the framework neither specifies what the proportionate measures are nor clarifies the scope of firms that are eligible for such proportionality. Hence, at this stage, the implementation of proportionality is insufficient to effectively reduce the regulatory burden for smaller insurers.

Solvency II has facilitated the integration of the Single Market for insurance services by improving the level-playing field and supervisory convergence. However, recent failures of insurance companies, which operated mainly outside the Member State where they were initially granted authorisation, highlighted shortcomings and deficiencies in the quality and coordination of insurance supervision, including of cross-border insurance groups. In addition, it also confirmed that policyholders are not consistently protected across the European Union in the event that their insurer fails, in particular in a cross-border context. Indeed, national resolution regimes are mostly incomplete and uncoordinated, and the patchwork of national insurance guarantee schemes (IGSs), which are expected to act as a safety net to pay policyholders' claims in the event of their insurer's insolvency, can leave some policyholders without any protection.

Finally, while policyholder protection is the primary objective of Solvency II, regulators and supervisors also have to preserve financial stability according to the Directive. To this end, supervising insurers on an individual basis ("micro-prudential supervision") may not allow addressing systemic risks in the insurance sector, since it does not really take into account their interconnections with other market participants and common risky (herding) behaviours among insurers. While some regulatory tools embedded in Solvency II already contribute to this objective, they may be insufficient and too narrow in terms of scope to effectively prevent the build-up of systemic risk in the insurance sector.

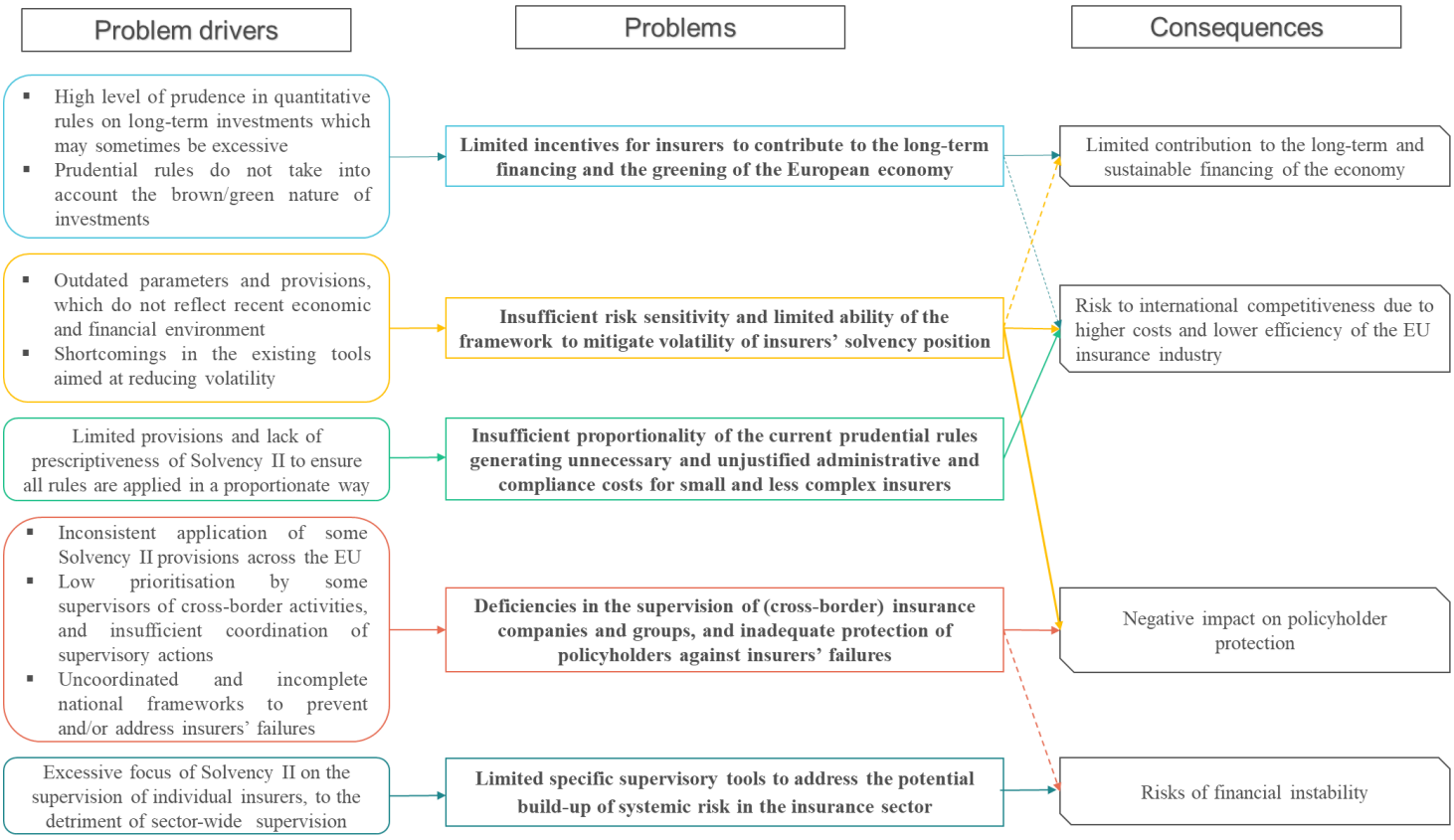
2. PROBLEM DEFINITION

The need for amending the Solvency II framework in order to either introduce new provisions or to review the existing ones has emerged as a result of both the conclusions of the evaluation of the Solvency II Directive (see Annex 10), and the outcome of the public consultation that was conducted between 1 July and 21 October 2020 (see Annex 2).

This section presents the most important problems addressed by this impact assessment. Those problems are further identified and assessed as part of the Evaluation Annex. Please also refer to Annex 7 for specific discussions on internal models and on reporting and public disclosure, which fall under the broader issue of quality of supervision (See 2.4) but will not be assessed as such in the core part of the Impact assessment due to size limitations.

Figure 1 summarizes the problems and problems drivers as well as their related consequences. Regarding the links between problems and consequences, the solid arrows correspond to the primary links whereas the dotted arrows correspond to the secondary links.

Figure 1: Problem tree



2.1. Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy

The main focus of Solvency II is policyholder protection and financial stability. To that end, Based on quantitative data (e.g. historical price and volatility behaviour of financial assets), it defines capital requirements, i.e. the amount of capital resources that insurers have to set aside in order for them to be able to cope with very extreme adverse events (1-year duration shocks whose probability of occurrence is only once in 200 years). Higher capital requirements on investments are therefore applied to assets, which are more volatile and/or more risky, for instance equity. However, since Solvency II was adopted, the European Commission set additional political objectives, notably the need to build-up a Capital Markets Union which can channel more funding to businesses and the European Green Deal to achieve a transition to carbon-neutrality. The capital requirements of Solvency II do not take into account the positive externalities of some investments in strengthening long-term sustainable growth and the economic recovery in the aftermath of the Covid-19 crisis and the limitation of the negative impact of climate change.

Limited incentives for insurers to contribute to the long-term financing of the economy

For the purpose of this impact assessment, the objective of fostering long-term investments will be actually related to the equity asset class only, since insurers are already largely investing in long-maturity bonds, as discussed in Sub-section 6.1.4 of the Evaluation Annex.

In addition, the concept of long-term investment has no commonly agreed definition. It cannot be restricted to "buy-and-hold" strategies. For the purpose of this impact

assessment, a long-term investment will be deemed an investment in an asset class (and not individual assets) with a long-term perspective (the Solvency II Delegated Regulation refers to a 5-year time horizon for long-term equity investments), including under stressed conditions. In other words, an insurer is deemed to make a long-term investment in equity if it can have a long-term perspective to hold a certain share of its investment portfolio in equities (listed, unlisted, private equity, etc.), even if it does some arbitrage operations from time to time (i.e. realising gains on certain equities and investing in other ones). From a prudential perspective, a long-term perspective encompasses the possibility for insurers to avoid forced selling under stressed market conditions.

The Capital Markets Union Action Plan underlined the instrumental role that insurers can play in the "re-equitisation" and long-term financing of the European economy. Insurers can hence support the economic recovery in the aftermath of the Covid-19 crisis. As shown in the Evaluation Annex, Solvency II, which only entered into application in 2016, is not the main driver of insurers' investments, since the downward trend in equity investments dates back to the beginning of the 21st century. The Commission made several amendments to the Solvency II Delegated Regulation to help insurers contribute to the long-term financing of the European economy, in particular by introducing a preferential treatment for long-term investments in equity, subject to some criteria[3]. However, those amendments are not sufficiently effective and the framework still includes disincentives to investments in assets such as equity, as insurance firms have to set aside more capital when investing in more volatile assets. To achieve the political objective of facilitating insurers' role in sustaining the economic recovery, prudential rules should be reviewed to facilitate long-term equity investments, while at the same time ensuring that such changes do not harm policyholder protection and financial stability. For further evidence, please refer to Sub-section 6.1.4 of the Evaluation Annex.

Insurers could contribute more to the greening of the economy

In relation to the European Green Deal, the Commission's Communication states that climate and environmental risks should be managed and integrated into the financial system. As regards insurers, the objective concerns both how insurers invest their money and how they take into account sustainability risks in their risk management concerning investments and underwriting of insurance risks. With respect to the former, insurers can play a role in closing the investment gap for environmental-friendly assets and activities. However, EIOPA estimates that only up to 5 % of the total asset value held by insurers may be eligible investments in sustainable assets (as identified by the taxonomy[4]), and therefore contribute to the climate objectives of the European Green Deal. This seems too low to achieve the Union's objective of a climate-neutral continent.

A first issue is probably the lack of available investable assets that are aligned with the taxonomy[5]. While the review of Solvency II will not address the need to foster the supply of sustainable assets, there is currently no explicit prudential incentive for insurers to invest in such assets. Indeed, the rules on capital requirements do not distinguish between

[3] Long-term equities are a regulatory asset class introduced by the European Commission in 2019. Equity investments that meet certain strict criteria can be subject to capital requirements that are between 44% and 56% lower than those applicable to "standard" equity investments.

[4] Throughout this document, "taxonomy" refers to the technical screening criteria for the identification of sustainable economic activities as adopted under Regulation (EU) 2020/852.

[5] As an illustration, the European Sustainable Finance Survey 2020 highlighted that only 2% of total revenue from CAC 40 and EURO STOXX 50 companies, and 1% from DAX 30 companies, are estimated to be fully taxonomy-aligned. This implies that the value of "green equities" stemming from the largest listed companies equals around € 40 billion in France and € 10 billion in Germany, to be compared with a total of insurers' investments of respectively € 2,700 billion in France and € 2,100 billion in Germany.

sustainable and other investments, and do not capture the possibly lower (respectively higher) level of risks over the long term of some categories of "green" (respectively "brown") assets, all else equal. Also, the positive (respectively negative) externalities of investing in such assets are not captured.

Furthermore, insurers are exposed to climate and environmental risks through their assets and liabilities towards policyholders. While Solvency II contains a general requirement on insurers to take into account all risks in their risk management, the Directive does also name particular risk categories explicitly. However, climate and environmental risks are not part of those risk categories and it would often materialise through other risk categories, e.g. market or underwriting risk. This may result in a lack of clarity as regards whether and where insurers are expected to reflect climate and environmental risks and, as a consequence, in insufficient management of those risks by insurers. For instance, only a small proportion of all insurance companies reflects climate change risks in their own risk and solvency assessment (ORSA). In 2020, EIOPA analysed a sample of ORSA reports from 1682 companies representing more than 80% of the EU insurance market. Only 13% of the analysed ORSA reports made a reference to climate change risk scenarios[6].

In conclusion, the prudential framework requires the same capital to be held for sustainable investment as for investment that do not qualify as sustainable. However, the financial risks of some categories of sustainable investments may already be lower or, notably with respect to transition risks, could be lower over a longer term. To achieve the political objective of private investments in the green transition, prudential rules should be reviewed to ensure that capital requirements on green assets are not higher than necessary to avoid harm to policyholder protection and financial stability. Furthermore, there is no clear obligation to manage and reflect climate and environmental risks. However, given their clear importance going forward, from both an economic and risk perspective, there may be room for appropriate regulatory adjustments in this area.

2.2. Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies

The economic and financial conditions faced by insurers over the recent years and months (in particular in relation to interest rate risks and market volatility) significantly differ from those present when the Solvency II framework was adopted[7]. Therefore, the Directive may contain outdated parameters and provisions, possibly resulting in an insufficient risk sensitivity and excessive volatility in some areas of the framework. The below subsections provide a few examples of such shortcomings.

Insufficient reflection of the low interest-rate environment in the Solvency II framework

As insurers are large investors in fixed-income securities (i.e. debt instruments that pay a regular fixed amount of coupon interest), it is commonly accepted that the current low – and sometimes even negative – interest rate environment is one of the main risks that EU insurers have been facing over the recent years. This is because they earn only low returns (or even make losses) which impact their profitability and solvency. This limits them in their ability to provide adequate insurance products for their customers. As shown in Sub-section 6.3.2 of the Evaluation Annex, between 2018 and 2020, the level of interest rates (for the euro) has significantly decreased, with a material adverse impact of both insurers' solvency position and profitability.

[6] EIOPA: Consultation Paper on the draft Opinion on the use of climate change risk scenarios in ORSA (EIOPA-BoS-20/561), October 2020, see Annex 1.

[7] The Solvency II Delegated Regulation was adopted on 10 October 2014.

In this regard, the underlying assumptions based on which the Solvency II capital requirements under the standard formula are designed are outdated, as they do not envisage the possibility for interest rates to move in negative territory, or when rates are already negative, to further decrease. Therefore, the prudential framework, which leads to an underestimation of the interest rate risk to which insurers are exposed, has not provided clear obligations to insurers for having capital to buffer for the risk of negative interest rates over a recent years, which has now materialised. If not addressed, this underestimation of the real risks to which insurers are exposed could become detrimental to policyholder protection, as insurers may not at some point have sufficient capital to absorb losses if the downward trend in interest rates continues in the future. Already in 2018, EIOPA estimated that this underestimation of interest rate risk represented on average 14 percentage points of solvency ratios at European level[8].

Sub-section 6.1.1 of the Evaluation Annex also shows that the current low interest rate environment raises doubts about the appropriateness of the stipulated regulatory interest rate curves that have to be used by insurance companies when valuing their long-term liabilities towards policyholders. As an illustration, the yield at issuance on a 100-year Austrian government bond (AA-rated) was lower than the 33-year regulatory risk-free interest rate in June 2020. An underestimation of the value of insurers' liabilities would lead to an overestimation of their solvency position, and may limit prudential incentives for insurers to establish robust asset-liability management strategies, with detrimental side effects on policyholder protection.

Insufficient ability of the framework to mitigate the impact of financial market turmoil on the solvency position of insurers.

In addition to being risk based, Solvency II relies on the pivotal principle of market-consistent valuation of assets and liabilities, which means that insurers have to rely as much as possible on market data when establishing their balance sheet. By nature, such characteristics imply high short-term volatility in insurers' assets (the value of which evolves with financial market movements) and liabilities (for instance, when asset values and asset returns collapse, the cost for an insurer of providing a high guaranteed rate on a life insurance product increases significantly). Those fluctuations in asset and liability values lead to a high volatility in the level of insurers' capital resources and more generally in their solvency position.

Solvency II also includes several regulatory mechanisms (so-called "long-term guarantee measures and the measures on equity risk"[9]) which are aimed at mitigating the impact of short-term market turmoil on insurers solvency position.

However, as evidenced in Sub-section 6.1.1 of the Evaluation Annex, those measures have proved to be insufficiently effective at mitigating excessive short-term volatility in the solvency position of insurers, in particular during market turmoil such as during March 2020 in the context of the Covid-19 outbreak. When the short-term volatility in insurers' solvency ratios becomes excessively high, it fosters short-termism in insurers' underwriting and investment activities. In particular, it may unduly incentivise life insurers to reduce their supply of long-term insurance products with guaranteed minimum returns, to shift a large part of the risk to policyholders (via the distribution of unit- or index-linked products), and to divest from real assets supporting the long-term

[8] See EIOPA's webpage. Note that the Commission at that time decided not to endorse EIOPA's advice but to discuss it as part of the broader review of Solvency II Directive where all topics in relation to interest rates could be discussed at the same time.

[9] For further explanations, see Section 2 and Sub-section 6.1.1 of the Evaluation Annex.

financing of the European economy. Also, if the treatment of long-term insurance products is unduly penalising for EU insurers, they may be put at a disadvantage compared to their non-EU competitors and will have less stable surplus capital (capital minus capital requirements) to expand internationally. Therefore, excessive volatility is also impeding international competitiveness of the European industry[10].

The Evaluation Annex also shows that the current parameters of the "long-term guarantee measures" sometimes give rise to unexpected improvements in the solvency position of some insurers, during crises such as the Covid-19 outbreak. Such unintended situations (called "over-shooting effect") raise supervisory challenges, because the existing regulatory framework may not result in appropriate risk measurement under stressed situations.

2.3. Insufficient proportionality of the current prudential rules generating unnecessary and unjustified administrative compliance costs for small and less complex insurers

Outdated thresholds of exclusion from the Solvency II framework

The Solvency II Directive already provides that very small insurers are excluded from the application of the Directive if they meet a series of cumulative criteria, including limited revenues (lower than EUR 5 million) and risk volume (insurers' liabilities towards policyholders of less than EUR 25 million).

As outlined in Sub-section 6.2.2 of the Evaluation Annex, the thresholds for exclusion have not been amended since the adoption of the Solvency II Directive in 2009. Therefore, those thresholds may be considered as outdated, although they will have to be updated to reflect inflation every five years, provided that the inflation since the last update is greater than 5%. The first update will therefore take place in 2021[11]. Still, the lack of reassessment of the appropriateness of thresholds may imply high compliance costs for small companies in the scope of Solvency II, which may not compensate the benefit of being subject to Solvency II.

Insufficient application of proportionate rules in Solvency II

The Solvency II framework broadly embeds the principle of proportionality, insofar as it requires ensuring that not only the requirements imposed to insurance companies, but also the intensity of the supervisory review process, are commensurate to the "nature, scale and complexity" of each company which is subject to Solvency II. Therefore, the application of the proportionality principle does not depend on the size of the companies but on the risks that they are facing. The framework as a whole is formulated in a modular manner, such that insurance and reinsurance companies must only apply those requirements, which are relevant to the risks they incur.

As Solvency II does not clearly define which firms can be subject to proportionality and which measures can be implemented in a proportionate way, the current framework results in legal uncertainty and lack of predictability for both insurers and NSAs. There is no report on the effective application of proportionality under Solvency II. However, Sub-section 6.2.2 of the Evaluation Annex concludes that the current framework results

[10] At this stage, not all countries have a risk-based and market value based framework. Therefore, in those countries, insurers' capital requirements may be less sensitive to market risks and the value of their liabilities may be less sensitive to changes in credit spreads. This lowers the volatility of those insurers' solvency ratio, although it makes them more exposed to the materialisation of market risks as the prudential framework would not appropriately reflect it.

[11] Five years after the entry into application of Solvency II.

in a limited implementation in practice of the proportionality principle. If not implemented in a proportionate way, Solvency II requirements become very challenging to comply with for smaller and less complex insurers, as their limited riskiness is not appropriately accounted for in supervisory review processes. This implies that the intensity of regulatory requirements is not sufficiently modulated so that they do not generate a disproportionate burden for small and non-complex insurers.

The issue of proportionality concerns all three pillars of Solvency II. However, the lack of proportionality in the implementation of prudential issues is particularly acute in relation to reporting and disclosure requirements by insurance companies ("pillar 3"). In this regard, Sub-section 6.2.1 of the Evaluation Annex shows that the information that must be publicly disclosed to policyholders proves to be too complex and too detailed, lacking a high-level simple overview. As regards data collection and reporting to NSAs, the Evaluation Annex underlines that the number and frequency of submission of the quantitative templates for regular reporting (often on quarterly basis) generates costs to both insurers and supervisors.

2.4. Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures

Inconsistent and insufficiently coordinated supervision of insurance companies and groups, including in relation to cross-border activities

Solvency II has facilitated the integration of the Single Market for insurance services by improving the level-playing field and supervisory convergence.

However, as shown in Sub-section 6.1.3 of the Evaluation Annex, recent failures of insurance companies, which operated mainly outside the country where they initially obtained their license, highlighted shortcomings and deficiencies in the quality and coordination of insurance supervision including in relation to cross-border activities. It also shows the insufficient prioritisation of some NSAs on the supervision of cross-border business[12]. EIOPA's coordination role, although reinforced in the context of the review of the Regulation (EU) 2019/2175 establishing the European Supervisory Authorities, proves to be insufficient in ensuring a high-quality convergent supervision across Member States. In addition, the lack of data sharing between NSAs may hinder the effective supervision of insurers operating on a cross-border basis.

Furthermore, the Evaluation Annex shows in the same Sub-section that due to legal uncertainties, several areas of the framework may not be sufficient for a harmonised implementation of the rules by insurers and NSAs, including in relation to the supervision of insurance groups. In particular, challenges arise from the supervision of groups that are headquartered or active in non-EEA countries, and of mixed financial groups combining banking and insurance activities (financial conglomerates).

Insufficient supervisory toolkit to intervene when firms are in financial distress

[12] This conclusion was also drawn by the European Court of Auditors (ECA) in its Special Report on EIOPA's actions to ensure convergence between national insurance supervisory systems in the EU between 2015 and 2017. The ECA identified "systemic weaknesses in the current supervisory system for cross-border business" that required legislative changes to ensure an equal level of supervision for companies running their business in another Member State, regardless of the chosen business model. Deficiencies in cross-border supervision were also identified by the International Monetary Funds, for instance in its Country Report No. 20/252 where one of the recommendations is to strengthen the national framework for the supervision of cross-border business and to allocate sufficient resources to it.

Although the Solvency II framework aims to minimise the likelihood of insurance failures, such likelihood is not brought to zero either. Recent failures, in particular of cross-border insurers, demonstrated that this risk remains not sufficiently addressed early, partly due to deficiencies in prudential supervision by some public authorities.

However, experience has also shown that, despite the existing Solvency II arrangements, the efforts to recover an insurer in financial distress are sometimes inefficient or run into legal or operational difficulties for a lack of proper and timely preparation of recovery options. Likewise, public authorities may fall short of options that could effectively avoid the winding-up of the insurer as they have not looked at failure scenarios and have not anticipated possible impediments to deploying alternative measures.

Furthermore, public authorities do not always have sufficient tools to avert the failure of insurers. As reported by EIOPA[13], one third of NSAs identified gaps and shortcomings in their range of recovery and resolution powers. Likewise, public authorities often lack alternatives to insolvency for failing insurers. Even traditional tools for an orderly wind-up such as run-off (i.e. a ban on writing new business while fulfilling existing obligations) and transfer of portfolios are either unavailable or subject to restrictions in some Member States. Other important powers to stabilise a failing insurer, such as stays on early termination rights, are only available in a small minority of Member States. Even in the few Member States equipped with the necessary tools, resolution approaches remain tailored to national objectives and constraints and could therefore differ widely (i.e. legal frameworks, scope of powers and tools, conditions for exercising these powers).

Finally, despite general cross-border coordination mechanisms for supervision, there is no clear framework for coordination and cooperation between authorities to prepare and manage a (near) failure of an insurance company operating across borders. As illustrated by EIOPA[14], this can result in conflicts of interest and a misalignment between the national accountability and mandate of supervisors (protecting the interest of policyholders at national level) and the cross-border nature of the insurance industry that is not coherent with the objectives of the Single Market. Cross-border cooperation and coordination is however essential to support recovery, eliminate impediments to an orderly resolution process and reduce suboptimal outcomes at the EU level. For further details, see Sub-section 6.1.3 of the Evaluation Annex.

Inadequate / insufficient protection of policyholders in case of failure

Currently, 17 Member States (and Norway) operate one or more IGS(s). This means that a significant share of gross written premiums are not covered by any IGS and that losses stemming from the failure of insurance companies can still be passed onto EU policyholders or taxpayers.

The current patchwork of national guarantee schemes means that policyholders across the EU are not equally protected. Gaps, but also overlaps[15], in the protection of policyholders can stem from substantial differences in the design features of existing national IGSs, notably in terms of geographical coverage. Therefore, for the same type of insurance policy, policyholders might benefit from a different level of IGS protection or no

[13] See EIOPA's Opinion on the harmonisation of recovery and resolution frameworks (2017).
[14] See for instance Boxes 13.2 and 13.4 of EIOPA's background analysis
[15] In some cases, insurers operating cross-border contribute to two national IGSs to cover the same policy.

protection at all, depending on where they live and on where they have contracted the policy.[16] For further details, see Annex 5 and Sub-section 6.1.3 of the Evaluation Annex.

Insurers in the EU may therefore face different costs and incentive structures, which can lead to an uneven level-playing field and add to the regulatory arbitrage previously described.[17]

2.5. Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

While policyholder protection is the primary objective of Solvency II, regulators and supervisors also have to preserve financial stability. To this end, supervising insurers and reinsurers on an individual basis without taking into account their interconnections with other market participants and common risky (herding) behaviours may not be sufficient to preserve financial stability.

Most rules of the Solvency II Directive are targeted to individual insurers (so-called "micro-prudential supervision"). Those provisions, for instance risk-based capital requirements, can help preventing systemic risk as they provide disincentives for excessive risk-taking. There are also several regulatory tools embedded in Solvency II that more directly contribute to preventing systemic risk, for instance by avoiding forced-sales of assets during market turmoil, which could amplify negative market movements.

However, according to EIOPA and ESRB, there are several shortcomings in the existing framework, which may limit public authorities' ability to preserve financial stability, and to address risks generated by the insurance sector itself. In particular, as further detailed in the Sub-section 6.3.2 of the Evaluation Annex, the current set of rules may not appropriately address issues of search-for-yield behaviours, high concentration of investment portfolios in certain assets and sectors, potential liquidity strains and insufficient coordination of macro-prudential measures, as illustrated during the Covid-19 crisis.

2.6. How will the problems evolve if not addressed?

For the purpose of this impact assessment, the baseline scenario will be to "do nothing" (this "baseline scenario" will be "Option 1" for each problem).

2.6.1. Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy

Doing nothing would generate opportunity costs for the wider economy in the form of lost output and overall welfare, by possibly preventing insurers from providing capital injections to businesses, notably SMEs, and from financing the transition to a carbon-neutral economy. This would not be coherent with the objectives of the CMU and the European Green Deal. It could also affect international competitiveness. Still, it can be argued that the higher risk of investing in equity justifies higher capital requirements, and that such an approach actually makes insurers' solvency more resilient to financial

[16] In some Member States, the guarantee schemes may cover all EEA policies issued by a domestic insurer or by a foreign branch of a domestic insurer. In other Member States, the schemes may only cover domestic policies issued by a domestic insurer or a domestic branch of a foreign insurer. As a result, policyholders of insurance branches may end up being covered by no national scheme.

[17] In particular, some Home supervisors may have less incentive to supervise insurers with business models concentrated on free provision of services in other Member States when these are not covered by national guarantee schemes that have to be financed by the domestic insurance industry. This situation can further undermine the integrity of the Single Market.

shocks in the long- run. Similarly, insurers that have already invested in sustainable assets may have less "free capital" which may affect competitiveness and the ability to offer products with guarantees to consumers. For further evidence on those different issues, please refer to Sub-sections 6.1.4 and 6.3.3 of the Evaluation Annex.

2.6.2. Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies

Not addressing the issue of insufficient risk sensitivity of the framework would have detrimental effect on the overall level of policyholder protection, and could foster risk-taking activities by insurers, with potential negative side effects on financial stability risks.

While volatility had been very low in recent years, it has sharply moved upwards as the Covid-19 crisis became virulent, and higher volatility seems to remain entrenched in the financial system. In consequence, without policy action, insurers might tend to reduce their investment time horizon and aim to shift market risks to policyholders (via the supply of unit-linked products) in a higher volatility environment. Finally, excessive volatility can generate procyclical behaviours, and therefore raise financial stability risks. Doing nothing would not be coherent with the renewed Action Plan on the CMU where it is acknowledged that volatility mitigation is key to help insurers provide long-term (capital) financing to the EU economy.

For further evidence on those different issues, please refer to Sub-sections 6.1.1 and 6.3.2 of the Evaluation Annex.

2.6.3. Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers

The high compliance cost of Solvency II[18] (3.18% of total operating costs, the highest one-off costs among the financial services frameworks[19]), could be a barrier to the entry and growth of new competitors in the Single Market, with undesirable effects in the offer of insurance products and/or in their price for policyholders[20] (higher fees). Therefore, doing nothing on proportionality may progressively lead to a less diversified landscape of insurers in terms of size and more concentration. The reduced competition in the sector could be detrimental to consumers.

In addition, as the conditions to apply the principle of proportionality are not clearly defined, insurers with a similar risk profile, could be subject to different rules depending on the Member State in which they are located, which is detrimental to the level-playing field in the EU.

[18] Note that as national prudential frameworks largely differ between Member States, it is not possible to have an overview of the difference between the compliance costs of Solvency II and those of national frameworks. However, an insurer can always request licensing (and therefore applying) Solvency II, if it considers that the national framework is more burdensome or more costly that Solvency II.
[19] See page 48 of the Study on the costs of compliance for the financial sector.
[20] For further evidence, please refer to Section 6.2 of the Evaluation Annex.

2.6.4. Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures

Doing nothing would leave unaddressed the inconsistencies and gaps identified in the Solvency II framework on the quality of supervision. Only relying on EIOPA's soft (non-binding) tools to ensure convergence in supervision is of limited effectiveness as supervisory authorities have no legal obligation to comply with those principles. Similarly, the problem drivers identified in Sub-section 6.1.3 of the Evaluation Annex and in the problem definition on policyholder protection in case of insurers' (near-)failures would remain, with the risk of late and not sufficiently prepared measures by insurers and/or public authorities in case of an insurer's distress. This could have a negative impact on policyholder protection and level-playing field as further Member States would probably establish national recovery and resolution frameworks to implement international guidance. Finally, doing nothing on IGSs would mean that Member States continue to take different approaches to IGS, including a total absence of IGS in some Member States. Uneven and insufficient levels of protection could undermine consumers' trust in the Single Market for insurance services.

For further details, see Annex 5 and Sub-section 6.1.3 of the Evaluation Annex.

2.6.5. Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

The baseline scenario would not impose new requirements on insurers and reinsurers, and therefore would allow avoiding additional compliance costs for them. In addition, the absence on new rules on investments or quantitative requirements (capital surcharge for systemic risk, concentration limits, etc.) would ensure that EU insurers' short-term competitiveness[21] is not affected.

However, doing nothing would not guarantee that supervisors have the powers to address systemic risk, which is not coherent with one of the main objectives of Solvency II (preserving financial stability). Furthermore, a lack of sufficient supervisory tools to prevent financial instability risks originating from the insurance sector would be negative for policyholders in the long term, since insurance failures may require public intervention and indirect costs for taxpayers. Furthermore, the economic and financial consequences of a crisis on social welfare go far beyond the sole insurance sector, and may concern the wider economy. It should be noted that the "holistic framework" for systemic risk, adopted by the Insurance Association of Insurance Supervisors and the Financial Stability board in November 2019, provides that supervisory authorities should have the power and mandate to identify, monitor and address, where necessary, the build-up and transmission of systemic risk in the insurance sector.[22]

3. WHY SHOULD THE EU ACT?

3.1. Legal basis

The Solvency II Directive provides for a comprehensive regulatory framework regarding the taking up and the pursuit of insurance and reinsurance (hereafter "insurance") business within the Union. The principle of regulating the taking-up and pursuit of the

[21] In case of the existence of systemic risks, leaving them unaddressed could have a very negative impact on insurers if those risks materialise in the long run.
[22] See the IAIS Insurance Core Principle 24.

business of insurance is long established at European level, and leaving this matter to the discretion of Member States would highly hinder the right of establishment and the freedom to provide services which European insurance companies benefit from to date. The legal bases of the current Directive are Articles 53(1) and 62 of the Treaty on the Functioning of the European Union. This would also be the legal basis for the envisaged introduction of a new minimum harmonised framework for insurance guarantee schemes. In order to continue to harmonise the rules at stake, or introduce these new harmonised rules, EU action in accordance with these Articles is needed.

On the envisaged harmonised framework for recovery and resolution of (re)insurers, which aims at ensuring a minimum level of harmonisation across the EU, the legal basis is Article 114 of the Treaty on the Functioning of the European Union.

3.2. Necessity and Added Value of EU action

The review aims to amend certain provisions of the Solvency II Directive, in particular those on capital requirements, on valuation of insurance liabilities towards policyholders, on cross-border supervision and on preventive recovery planning. It also aims at providing necessary clarifications and changes to the principle of proportionality. With regard to these particular issues, only EU action to clarify these provisions will ensure that going forward, these regulatory provisions are applied uniformly and guarantee the existence of the well-established regulatory framework regarding the taking up and the pursuit of insurance and business, which are essential for the Single Market.

In addition to amendments of existing rules, the review will consider the introduction of new dimensions in Solvency II, notably in relation to climate change and environmental risks, to the harmonisation of national frameworks for resolution, and to macro-prudential tools. In addition, the impact assessment will contemplate putting forward a stand-alone proposal for a minimum harmonisation framework for insurance guarantee schemes. The necessity and added value of EU action on those areas is justified in the next paragraphs.

Climate change and environmental risks: The limited incentives for insurers to contribute to the greening of the economy could possibly be addressed through individual actions by Member States. In fact, given the commitments to environmental and climate policy goals, both at international (e.g. Paris Agreement) and at Union level, it is very likely that more Member States and NSAs will explore options of ensuring a contribution by the insurance sector. The lack of clarity on the relevance of sustainability risks in current prudential rules could however be exacerbated by parallel and uncoordinated attempts by Member States in that field which would undermine the Single Market for insurance services. Thus, such clarification needs to be provided at Union level so that insurance companies operating in several Member States comply with rules within a single framework and for supervisory authorities to coordinate and align actions within that framework (instead of segmenting the market via different actions and rules).

Resolution: A minimum harmonised resolution framework for insurers, aiming to address situations where an insurer is no longer viable or likely to be no longer viable[23], would ensure a common approach to address and mitigate the consequences of an insurer's failure across the EU, thereby fostering cross-border cooperation and coordination. If applied in a proportionate manner, this could improve the functioning of the Single Market, ensure that the overall framework is suitable to maintain a high level

[23] This would encompass the establishment of a national resolution authority, the introduction of a common set of resolution objectives, powers and tools.

of protection for policyholders and beneficiaries and contribute to preserving financial stability in the EU.

Insurance guarantee schemes: Currently, in the event an insurer fails, a patchwork of national schemes is in place across the Member States, which can step in. These guarantee schemes offer different levels of protection, cover a different scope of insurance products and have different geographical scopes. Solvency II does not contain substantive provisions on IGS. It only contains a provision providing that host Member States may require non-life insurers from other Member States selling insurance products on their territories through branches or cross-border sales to join and participate in their IGS. Combined with the increasing share of cross-border activities within the EU Single Market and the absence of adequate cross-border mechanisms for compensation, the current situation results in an inefficient and incomplete protection for policyholders and other beneficiaries. Establishing mechanisms that would address these issues would not be possible without EU action. Only an EU action can ensure consistently that all policyholders and beneficiaries acquiring insurance policies in the EU benefit from a minimum level of protection in the event that their insurer fails, and in particular in cross-border situations. EU action would also be necessary to create an appropriate and consistent incentive structure across the EU that is conducive of market discipline by involving the insurance industry in the financial consequences of an insurance failure[24].

Macro-prudential supervision: Solvency II is at this stage mainly focused on micro-prudential supervision (i.e. the supervision of individual insurers) with the aim of protecting policyholders, but the Directive also mandates supervisors to preserve financial stability. Under certain (and so far limited) circumstances, insurance activities can indeed originate or amplify systemic risk. An action at EU level to integrate (targeted) macro-prudential elements within the Solvency II Directive would ensure uniform application of the new provisions. As financial stability does not have national borders (in particular since insurance companies and groups largely operate on a cross-border basis), an EU action (aiming to ensure that public authorities are granted sufficient powers allowing them to adopt appropriate and coordinated supervisory responses to systemic risks in all Member States) would contribute to the financial stability in the whole Union. This would also be consistent with the approach followed by banking regulation where macro-prudential supervision is framed at EU level. Finally, the scope of the amendments would have to be sufficiently targeted in order to ensure consistency with the existing instruments that have been designed as micro-prudential but may also have a macro-prudential relevance (e.g. the ORSA, which is the process by insurers to assess their exposures to all quantitative and qualitative risks, or the prudent person principle which requires insurers to monitor risks related to their investment activities,).

4. OBJECTIVES: WHAT IS TO BE ACHIEVED?

4.1. General objectives

The review of Solvency II will aim to achieve the following general objectives:

- Increase insurers' contribution to the long-term and sustainable financing of the economy;
- Enhance the protection of policyholders;
- Contribute to financial stability;

[24] See notably measures to reduce moral hazard risk and align incentives in the Organisation of Economic Cooperation and Development's paper: "*Policyholder Protection Schemes: Selected Considerations*" (2013)

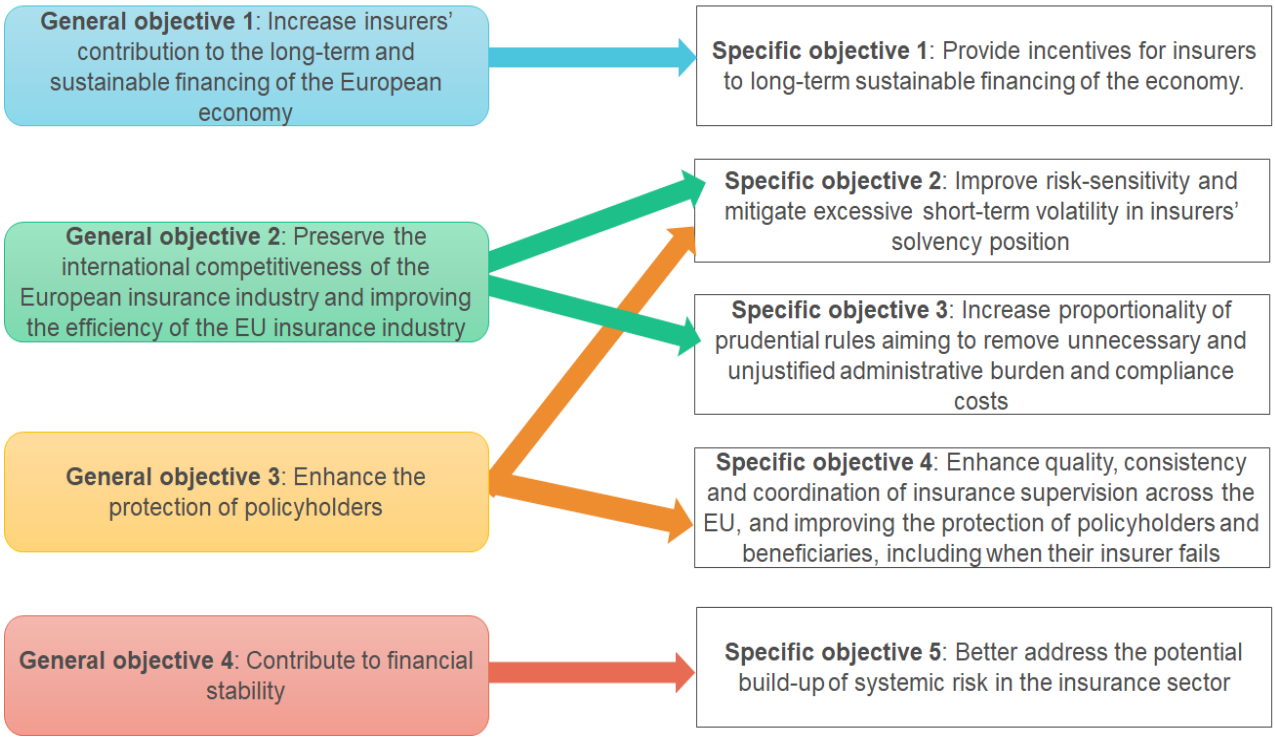
- Preserve the international competitiveness of the European insurance industry and improving the efficiency of the EU insurance industry.

4.2. Specific objectives

The impact assessment will consider the following five specific objectives:

- Provide incentives for insurers to long-term sustainable financing of the economy (hereafter "*LT green financing*")
- Improve risk-sensitivity (hereafter "*risk sensitivity"*)
- Mitigate excessive short-term volatility in insurers' solvency position (hereafter "*volatility*");
- Increase proportionality of prudential rules aiming to remove unnecessary and unjustified administrative burden and compliance costs (hereafter "*proportionality*")[25] ;
- Enhance quality, consistency and coordination of insurance supervision across the EU, and improve the protection of policyholders and beneficiaries, including when their insurer fails (hereafter "*supervision / protection against failure*");
- Better address the potential build-up of systemic risk in the insurance sector (hereafter "*financial stability*").

Figure 2*: links between general and specific objectives*



[25] NB: we will also include the dimension of simplification as part of this specific objective as a simpler framework also contributes to reducing compliance costs and administrative burden.

5. WHAT ARE THE AVAILABLE POLICY OPTIONS?

5.1. Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy

The "preferred policy option" may be a combination of one option in relation to the long-term financing of the European economy (among Options 2 or 3) and another one in relation to the greening of the European economy (among Options 4 and 5).

Option label	Option description
Option 1: Do nothing	This is the baseline scenario.
Option 2: Facilitate long-term investments in equity	Loosen eligibility criteria for the preferential treatment on long-term equity investments[26], with the aim of extending the scope of equities that may be subject to that preferential treatment. This is in line with EIOPA's general approach[27].
Option 3: Reduce capital requirements on all equity investments	Proceed to a general decrease in capital requirements on all equity investments, without any restriction (no reference to any long-term perspective or long-term nature of the investment).
Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	Strengthen the qualitative risk-management requirements to ensure that insurers appropriately monitor, manage and mitigate climate change and sustainability risks, as recommended by EIOPA
Option 5: Strengthen "Pillar 2" requirements and incorporate climate change and sustainability risks in quantitative rules	In addition to Option 4, quantitative rules would be amended so that they depend on the "green" nature of insurers' investments, i.e. all else equal, insurers investing more in "green" assets would have a better solvency position (i.e. higher capital resources over capital requirements) than others.

Options discarded at an early stage

A complement to Option 5 could have been an option where additional disclosure requirements in relation to climate change and environmental risks are introduced in Solvency II, so that external stakeholders are fully informed about the sustainability of insurers' activities. However, the communication on the European Green Deal underlined that the Commission intends to review the Non-Financial Reporting Directive (NFRD) the scope of which goes beyond the insurance sector, in order to extend "green" disclosure requirements to all types of financial market participants through one single piece of legislation. Therefore, in order to avoid overlapping disclosure requirements for insurers in different Directives, the option of introducing specific green disclosure requirements for insurers is not assessed in the context of this initiative. However, should gaps in the disclosure requirement for the insurance sector remain after the review of NFRD, amendments to Solvency II rules on disclosures could be considered.

[26] Long term equity investments are a regulatory asset class which were introduced in Solvency II in 2019. Investments in equity fall under this category if they meet certain criteria defined by the framework. The adjustments to the criteria include a simplification of the approach to demonstrate the ability of insurers to stick to their investments under stress, a simpler requirement in relation to how the assets and liabilities should be managed (removal of the so-called "ring-fencing requirement").

[27] Please refer to section 2.8 of EIOPA's opinion.

In relation to amendments of quantitative requirements, an alternative or a complement to Option 5 could have been to amend quantitative rules so that all else equal, insurers investing in environmentally harmful ("brown") assets would have a lower solvency position than other insurers (i.e. prudential rules would penalise "brown investments"). However, contrary to green assets, there is no commonly accepted European definition of "brown" investments. Without such a definition, it would be very challenging (if not impossible) to define penalising factors for brown investments and to assess the quantitative impact of such an option. Therefore, such an option has been discarded at this stage, but could be reconsidered if a taxonomy for "brown assets" were to be developed. In addition, a standalone approach for the insurance sector which would not be consistent with other financial market participants is not deemed appropriate.

5.2. Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies

Option label	Option description
Option 1: Do nothing.	This is the baseline scenario.
Option 2: Fix all technical flaws in relation to risk sensitivity and volatility	Under this option, changes that are technically justified and aiming to address risk-sensitivity and/or volatility would be adopted, broadly in line with EIOPA's advice: - To improve risk-sensitivity, incorporate negative interest rates in standard formula capital requirements and better take into account market rates used to value long-term insurance liabilities; - To reduce undue volatility, amend the long-term guarantee measures in order to improve the volatility-mitigating effect of the framework.
Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes	Under this option, the changes presented in Option 2 would be implemented, subject to a phasing-in period aiming to smoothen the impact of the amendments over time. In addition, some additional measures would be taken in order to mitigate (part of) the long-term increase in capital requirements resulting from those changes[28].

No option was discarded at an early stage.

5.3. Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers

In order to avoid excessive compliance costs, two elements can be combined: first, a further extension of the thresholds of the Directive (see Article 4) which would directly exclude from its mandatory scope a higher number of small insurers; second, new measures to reduce and simplify prudential rules for those insurers that would continue being in the scope of Solvency II. While the first element would address the problem of

[28] In other words, while Option 2 is designed to maximise the objective of sound prudential framework (by making it more risk sensitive and improving its technical volatility-mitigating tools), Option 3 takes into account also the cumulative impact on capital requirements and tries to draw a trade-off between the objective of risk sensitivity and the one of not overburdening insurers so that they can continue to help the economy and the green transition and to remain competitive at international level

lack of proportionality for the smallest firms, only the second element would improve the application of the proportionality principle for the rest of firms, by not relying only on size. Therefore, only a combination of elements would allow an optimal solution.

Option label	Option description
Option 1: Do nothing	This is the baseline scenario.
Option 2: Exclude a significant number of firms from Solvency II and enhance the proportionality principle within Solvency II	Proportionality would be implemented as follows, in line with EIOPA's general approach: - Increase significantly the thresholds of exclusion from Solvency II. The thresholds on risk volume would be doubled (from EUR 25 million to EUR 50 million) in order to ensure that only the less risky insurers are left out of the scope of Solvency II, and the thresholds on revenues would be extended from EUR 5 million to EUR 25 million. - Consequently, a large number of firms would no longer have to apply Solvency II, but would be subject to national specific regimes. - A certain number of additional firms subject to Solvency II would be identified, based on criteria, as being of "low-risk profile" and would benefit from automatic application of all Solvency II proportionality measures which would be clearly specified in the legislation.
Option 3: Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.	Proportionality would be implemented in the following way: - Less firms would be excluded from the application of Solvency II than under Option 2 (the thresholds on revenues would be multiplied by 3 instead by 5, as in Option 2)[29]. Solvency II would still apply to more firms than in Option 2, but a larger number of those firms would be classified as low-risk profile and would benefit from automatic application of Solvency II proportionality measures, which would be clearly specified in the legislation and extended compared to Option 2. - A larger number of insurers would remain in the scope of the European framework, but compliance costs would be significantly reduced for those that meet the conditions to benefit from proportionality measures.

Options discarded at an early stage

Alternative options could have been different exclusion thresholds that are lower than the changes proposed in Options 2 and 3. However, in view of the limited impact of such lower changes, those options, which were also tested by EIOPA, were discarded. Similarly, one could have envisaged a further increase in thresholds than the one proposed by EIOPA (as reflected in Option 2). However, in view of the downsides of Option 2 which are specified in the next section, this alternative option, which was also discarded by EIOPA, has not been considered in this impact assessment.

[29] More precisely, the threshold on revenues would be multiplied by three instead of by five (i.e. from EUR 5 million to EUR 15 million – instead of EUR 25 million like in Option 2).

5.4. Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures

For the purpose of analysing this problem, different policy options will be considered in order to address the issues of:

i. Inconsistent and insufficiently coordinated supervision of insurance companies and groups, including in relation to cross-border activities
ii. Insufficient supervisory and resolution toolkit to address insurers' distress
iii. Inadequate protection of policyholders in case of failure.

Option label	Option description
Option 1: Do nothing	This is the baseline scenario.
Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision	Under this option, the framework would be clarified and strengthened so as to ensure more quality and convergence of supervision of insurance firms and groups. More requirements for cooperation between Home and Host[30] supervisory authorities would be introduced, and EIOPA's coordination role would be strengthened. This is in line with EIOPA's general approach.
Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner.	Under this approach, minimum harmonising rules would be introduced, with the aim of providing public authorities with a toolkit to prevent and manage insurance failures, in particular by requiring ex ante[31] planning of remedial actions in case of insurers' (near-)failures, and by strengthening cooperation rules between authorities. This is in line with EIOPA's advice.
Option 4: Introduce minimum harmonising rules to protect policyholders in the event of an insurer's failure	Under this approach, minimum harmonising rules would be introduced so that each Member State has to establish safety nets to protect policyholders when their insurer fails ("IGSs"). This is in line with EIOPA's general approach.

Note that due to size constraints, the policy options do not explicitly refer to topics of internal models, and reporting and disclosure, although those aspects fall under the issue of quality of supervision. The dedicated impact assessment of each of those topics is presented in Annex 7. In addition, Annex 5 provides a further technical analysis of the different features of the design of harmonised rules on insurance guarantee schemes.

Options discarded at an early stage

Further options which could have been considered include an EU-centralisation of supervision and resolution. However, in view of the outcome of the ESAs review, the integration of micro-prudential supervision and of resolution is not deemed politically mature at this stage. Similarly, a further option for policyholder protection in cases of failure would be the creation of a single IGS for the entire EU. This would increase the insurance effect of mutualisation and would thus require lower resources from the

[30] For the purpose of this problem, the "Home" supervisory authority is the authority of the Member State where an insurer got its license. The "Host" supervisory authorities are the authorities of the Member States – other than the "Home" Member State – where an insurer is operating.

[31] "*Ex ante* planning*"* means that the planning takes place before the adverse situations/conditions materialize.

insurance industry. However, a single EU-wide IGS would not be consistent with the existing national micro-prudential supervisory framework.

5.5. Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

Option label	Option description
Option 1: Do nothing	This is the baseline scenario.
Option 2: make targeted amendments to prevent financial stability	Under this option, targeted changes would be made to the framework, in order to incorporate macroeconomic and macro-prudential considerations in requirements on insurers' investment and underwriting activities, and to better monitor liquidity risk.
Option 3: introduce an extensive macro-prudential framework	An extensive macro-prudential framework would be introduced, which would include, in addition to the changes envisaged as part of Option 2, the power for supervisors to impose systemic or countercyclical capital buffers, or concentration limits on investments. This is the approach put forward by EIOPA and the ESRB.

Options discarded at an early stage

An additional consideration could have been to fully centralise macro-prudential supervision at European level (e.g. at the level of EIOPA or the ESRB). While such an approach could be effective in addressing European-wide systemic risks (as systemic risks do not have borders and coordination of national responses is probably needed to effectively preserve financial stability in the Union), this idea has been discarded as too far-reaching. Indeed, the macro-prudential dimension in Solvency II remains limited at this stage according to some stakeholders. It is therefore needed, as a first step, to contemplate enhancements of the current set of rules (where deemed justified) before considering significant changes to institutional/governance arrangements on the use and implementation of such new tools. In addition, in light of the limited success of the Commission's attempt to strengthen the centralisation of micro-prudential supervision by EIOPA[32], it would be unlikely that the centralisation of macro-prudential supervision would receive meaningful political support from Member States, before agreeing on the necessity to embed a macro-prudential dimension in Solvency II.

6. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS AND HOW DO THEY COMPARE?

In this section, each policy option considered (other than Option 1 – "No change") will be assessed against the specific objectives presented in Section 4. The baseline scenario ("Option 1 – no change" of each problem) will not be assessed in this section. The consequences of doing nothing are outlined in Section 2 of this impact assessment.

[32] In the context of the review in 2019 of the Regulation establishing EIOPA.

6.1. Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy

6.1.1. Option 2: Facilitate long-term investments in equity

Under this option, the eligibility criteria for benefiting from the preferential treatment applicable to "long-term equity" assets would be loosened, with the aim of expanding the share of equity investments that can fall under this regulatory asset class. This is the general approach recommended by EIOPA in its advice. The revised criteria would still rely on the principle that an insurer may only benefit from a preferential treatment if it is able to avoid forced selling under stressed conditions. Other criteria would ensure that insurers have a long-term perspective when making equity investments which they want to classify as long-term equities.

Benefits

Option 2 would positively contribute to remedying the lack of **incentives for insurers to contribute to the long-term and sustainable financing of the European economy**. As demonstrated in Sub-section 6.1.4 of the Evaluation Annex, although Solvency II is not the main driver of equity investments, the prudential framework can also bias insurers' investment behaviours. By relaxing some of the eligibility criteria for long-term investments in equity (while still ensuring that insurers' policies incorporate the long-term perspective in their investment decisions), insurers would be able to apply the preferential treatment to a wider scope of equities and therefore to increase the amount of equity investments. In other words, facilitating long-term investments in equity would imply increasing insurers' equity exposures. More capital could hence be injected in businesses, in particular SMEs. In addition, as the greening of the economy also requires stable financing, a facilitated preferential treatment for long-term investments in equity could also contribute to financing sustainable activities (indeed, criteria for long-term equities leverage on the objective of long-term investing time horizon). EIOPA has asked the industry to quantify the impact of one set of criteria, but its final advice goes further than what was tested, notably by allowing for more flexibility in the way life insurers may demonstrate their ability to stick to their investments. Therefore, EIOPA's impact assessment (related to the initial set of criteria) provides a lower bound estimate of the impact of its final advice[33]. Therefore, based on those figures, Option 2 could thus result at least in a doubling of the number of insurance firms which are willing to use the long-term equity asset class, and a multiplication by almost six of the amount of equities eligible to a preferential treatment (from € 4.2 billion to € 26 billion). This implies that at least € 3 billion in capital would become available for covering capital requirements for further investments in equity (assuming insurers are willing to maintain their solvency ratio constant).

Option 2 would also have a moderately positive impact on **international competitiveness**. Indeed, if insurers are required to establish lower buffers when investing in equity, they would have more free capital surplus (i.e. excess capital resources over capital requirements) to expand internationally. The likely beneficiaries would be the shareholders of insurance companies.

Finally, Option 2 would also allow improving **supervisory convergence and level-playing field** by providing more clear-cut and unambiguous criteria to the eligibility of equities for the preferential treatment.

[33] For further details on EIOPA's impact assessment on the review of the prudential treatment of long-term equity investments, please refer to EIOPA's impact assessments, from page 146 to page 160.

Costs

EIOPA's analysis suggests that the existing calibrations for equity are appropriate and that financial data do not support the preferential treatment on long-term equity investments which was introduced by the Commission in 2019. However, EIOPA did not recommend removing the long-term equity category, but concluded on the contrary that policyholder protection and risk sensitivity would remain at a very high level if the revised eligibility criteria remain sufficiently robust and clear. Therefore, Option 2 would have a moderate negative impact on **the risk-sensitivity** of the framework (i.e. only in relation to equity investments). While Option 2 is not aimed at addressing the issue of volatility, one may note that since equity can prove to be more volatile than other asset classes, more investments in equity (stemming from the further use of the long-term equity asset class) could lead to further volatility in insurers' assets. On the other hand, those additional (long-term) equity investments would be possible to the extent that the insurer is able to stick to its investments, including under stressed conditions, and is therefore not exposed to short term volatility in stock markets. Option 2 could also have a **limited but negative impact on financial stability**. Indeed, insurers would have more incentives to invest in equity, and therefore to hold on average assets with higher risks of material loss in market value in a short period of time (i.e. more volatile assets). On the other hand, the prudential criteria would be defined in such way that supervisors have the assurance that insurers would not be subject to forced-selling of equities at deteriorated price under stressed conditions[34]. Therefore, the revised eligibility criteria would be such that insurers would not be likely to amplify the negative externalities of an exogenous shock on stock markets, as they could weather the drop in equity prices due to the long-term nature of their investments. On balance, it is thus expected that this option would not generate material systemic risk.

In terms of **implementation costs,** based on a survey conducted by EIOPA, there would be significant one-off implementation cost of applying Option 2 in the view of about 20% of participants to the holistic impact assessment. A similar share (24%) are of the view that there would be material increase in on-going compliance costs. Those costs are associated with updating IT systems to comply with updated requirements and trainings to ensure staff is aware of regulatory changes. However, as the criteria are assumed to be clearer than under current framework, those costs are expected to decrease relatively quickly over time.

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would contribute to removing barriers to equity investments. Hence, it would enlarge the productive capacity of the economy[35] and thus generate welfare. It would also have a positive impact on international competitiveness as evoked above. Option 2 would generate limited implementation costs and have limited negative impact on policyholder protection and financial stability, since the preferential treatment would only be possible if insurers meet a set of robust eligibility criteria. It is also coherent with the CMU objectives which explicitly refer to the need to facilitate insurers' contribution to the "re-equitisation" of the European

[34] Insurers would have to demonstrate that they can stick to investments under stressed conditions (i.e. for instance that they are not exposed to forced selling under assumptions of massive surrenders, and/or that they could sell other liquid assets if they need to generate cash).

[35] As explained in Sub-section 6.1.4 of the Evaluation Annex, insurers provide a lot of debt financing. However, in order for businesses (in particular SMEs) to expand or grow, they also need to avoid being too much indebted and thus need capital financing. This is all the more the case in the context of the ongoing Covid-19 crisis where businesses in several countries had access to grants and loans, but are now facing high level of indebtedness while facing strong uncertainty in terms of economic outlook.

economy, and overall does not materially affect the risk-based nature of Solvency II (limited negative effect). Finally, it generates a necessary condition for enabling the European Green Deal, as "green" assets and activities require long-term funding including in equity investments, although it must be understood that there is no guarantee that all insurers' long term investments are "green".

Winners and losers: Policyholders would be "winners" to a certain extent. Indeed, despite limited negative impact on policyholder protection, they may benefit from the moderate increase in risk-taking by insurers by receiving higher returns on their life insurance policies as insurance companies would generate higher returns on their investments[36]. By being allowed to take additional risks, insurance companies can generate a higher return to their shareholders at limited additional costs. The impact of supervisors would also be positive, as the new criteria would be clearer than the existing ones, making it less complex to supervise insurers' compliance with regulatory requirements. Finally, businesses, in particular SMEs and those conducting green activities, would benefit from easier access to equity funding by insurance companies.

Stakeholder views: In the context of the Commission's public consultation, among those stakeholders who expressed a view on equity financing, more than 50% of stakeholders consider that the current framework still includes obstacles to long-term investments. This is particularly the case for insurance companies (66%) and public authorities (75%). Only 30% of citizens/consumers/NGOs share this view, but the remaining 70% expressed no opinion on this question. In the context of EIOPA's technical consultations on the review, the vast majority of insurance stakeholders support an alleviation of the criteria on long-term equity, although they may disagree on the very specific criteria that should be retained.

6.1.2. Option 3: Reduce capital requirements on all equity investments

Under this option, all capital charges on equity would be reduced[37]. Therefore, the average cost of investing in equity would be reduced for all insurers, without any criteria, and regardless of whether the investment is "long-term" or not. This option, which has been put forward by a few stakeholders, including public authorities in different Member States, would be justified by the choice of giving priority to the political objective of facilitating insurers' capital financing of the economy, in accordance with the objectives of the Capital Markets Union Action Plan, even if the lack of evidence to justify such an approach would be in conflict with the primary objectives of Solvency II, namely policyholder protection and financial stability.

Benefits

Option 3 would be more effective than Options 1 and 2 in addressing the insufficient **incentives for insurers to contribute to the long-term and sustainable financing of the European economy**. By proceeding to a general decrease in capital requirements on equity regardless as to whether the investment is intended to be held for the long term or not, the prudential cost of investing in equity would be materially reduced, which implies

[36] In life insurance, many insurance products are subject under national laws or contractual arrangements to minimum "profit sharing" mechanisms, according to which policyholders are entitled to benefit from some of the return on insurers' investments. Therefore, those additional returns cannot in general be just distributed to shareholders through dividends.

[37] A floor would however be set so that capital charges on equity can never go below the current most preferential treatment (i.e. 22% risk factor). The calculations are relying on information provided by EIOPA.

a larger amount of additional "free capital" which may be invested in equity[38]. EIOPA did not conduct any impact assessment of this option. However, on the basis of the quantitative data submitted by insurers to NSAs, and based on simplified assumptions, one can estimate that a 3 percentage point decrease in capital charges on equity frees about € 5 billion of capital (which could potentially be used to invest in equity)[39]. In principle, this additional capital could also be invested in "green" assets and therefore contribute to the objectives of the European Green Deal. However, as no conditionality would apply, there is no guarantee that capital be invested in climate-friendly activities, or even in equity more broadly. Option 3 would also be more effective than the previous options in **improving EU insurers' competitiveness** at international level and thus benefitting insurers and their shareholders. Option 3 would free-up more capital than under Option 2, which could be used to expand internationally and thus generate additional profit for insurance companies.

Finally, depending on the way this option is implemented, Option 3 could have a **positive impact on the simplification** of the framework. Indeed, if capital requirements on all equity investments were lowered to the same level regardless of their nature, this would materially simplify the framework by removing the existing patchwork of regulatory asset classes of equity investments (currently, they are at least eight different classes of equity investments in Solvency II).

Costs

Option 3 would **materially reduce the risk-sensitivity of the framework**. EIOPA notes that calibrations of capital charges on equity investments are already lower than what it advised when finalising the Solvency II framework before 2016. Therefore, a further general decrease in capital requirements on equity investments would not be justified based on available evidence. In addition, a general decrease of capital requirements in equity investments regardless of their nature (listed or unlisted equity, strategic or not strategic, etc.) would undermine the risk-based nature of the framework. This would also affect policyholder protection, by incentivising insurers to take much more risks, with a greater likelihood of insurance failure.

While not aiming at affecting volatility, the expected effect of Option 3 is to dramatically increase insurers' exposure to equity. As equity investments prove to be relatively more volatile than other asset classes, a significant increase in equity exposures would probably make insurers' assets, and therefore solvency positions, **materially more volatile**.

Option 3 would imply a deviation from the risk-based approach whereby capital requirements are calibrated using evidence on their riskiness. This may cause supervisory authorities to pursue other tools to address the potential underestimation of the risk in the calculation of capital requirements, such as intensified supervisory monitoring, or even a capital add-on or requests by the supervisory authority to calculate capital requirements with an internal model that models equity risk in a fully risk-based manner. In such a scenario, the tools chosen by supervisory authorities are likely to differ and the option would therefore be **detrimental to the consistency and coordination of supervisory practices and thus undermine the Single Market for insurance services.** On the other

[38] The capital gains could also be used to invest further in any other asset class. However, it is expected the lower relative cost of investing in equity for a given amount of capital resources available would incentivise insurers to invest a larger share of their investment portfolio in equity, which are supposed to provide higher returns than some other asset classes (e.g. bonds).

[39] The assumptions include the setting of a floor of 22% for capital charges on equity, and a level of diversification benefits in capital requirements of 45%.

hand, Option 3 would simplify the prudential framework for equity investments compared to the current situation where criteria for long-term equities are subject to interpretation[40]. Therefore, the **Option 3 would allow simplifying the framework, but at the cost of materially increasing risk exposure by insurers**.

Option 3 would have a **potential very negative impact on financial stability**. By proceeding to a general decrease in capital requirements which would not be supported by quantitative evidence (but would be justified by the priority given to achieving the CMU objectives over the primary objectives of the Solvency II Directive), Option 3 would provide wrong risk-management and investment incentives to insurance companies. The risk of excessive risk-taking (search for higher return) could generate bubbles and would expose insurers to sudden trend reversals in stock markets. In addition, Option 3 could imply windfall effects by generating an immediate broad increase in free capital, which could be simply used by insurers to make more dividend distributions to shareholders or share buy-backs instead of providing additional funding to the real economy. This risk is material. Option 3 would allow reducing capital requirements without any change in insurers' behaviours. This would imply that without any change in the risk profile, the average solvency ratio could be maintained constant despite the level of capital resources would be reduced due to opportunistic higher dividend distributions. In comparison, this risk would be deemed minor in Option 2 because in order to benefit from a capital relief, insurers would still have to revise their internal investment policies and change their approach to equity investments so as to embed long-termism in their investment decisions. They would also have to document their ability to stick to their investments under stressed situations (which implies that their solvency ratio would be sufficiently high to not be subject to forced selling of equities with the aim to de-risk their investment portfolio and reduce capital requirements). Therefore, opportunistic dividend distributions would be less likely or would make it more difficult for insurers to demonstrate their intention and ability to invest for the long term.

As regards **implementation costs**, although there is no available data, as this option could simplify the framework, it is expected that the one-off implementation cost would be lower than in Option 2 (need to update IT systems) and the on-going implementation costs would be almost null (simplified approach compared to today).

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would probably be the most effective in removing barriers to equity investments, and improving insurers' international competitiveness, but at the cost of materially deteriorated policyholder protection and risk sensitivity and higher financial stability risks. There would also be a lack of coherence with the primary objective of Solvency II (policyholder protection). Also, the CMU Action Plan highlights that the facilitation of insurers' long-term sustainable financing of the economy should not be to the detriment of financial stability.

Winners and losers: In the short term, policyholders would probably benefit from the increased risk-taking by insurers by receiving higher returns on their life insurance policies as insurance companies would generate higher returns on their investments. However, in the long run, they would be the losers due to the higher risk of failure of their insurer. Insurers and their shareholders would be the winners as insurance

[40] For instance, one of the criteria is that the insurer is able to avoid forced selling of equities in stressed situations. However, the current framework does not specify how to demonstrate that this criterion is fulfilled.

companies would have more free capital to invest (and therefore higher return to pay to shareholder) with no conditionality. On the other hand, it is clear that in the long run, if excessive risk taking in equity leads to an insurance failure, this would be detrimental to shareholders. For supervisory authorities, while this approach would probably simplify the supervision of compliance with regulatory requirements, this would also require more active supervisory dialogue with insurers in order to compensate the higher risk of failure stemming from potential excessive risk-taking. This would also entail the need for a more active macro-prudential supervision.

Stakeholder views: The same remarks as in Option 2 apply as regards the need to bring changes to the prudential framework on equity. The principles embedded in Option 3 have not been formally consulted by EIOPA. However, while it can be expected that a majority of insurance stakeholders would support Option 3, only a minority of supervisory authorities expressed interest in such an option. In addition, in the context of the Commission's consultation, several stakeholders, including citizens/consumers/NGOs, highlighted the need to ensure that the changes brought to Solvency II do not generate financial stability risks (which may imply dismissing Option 3).

6.1.3. Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks

Under this option, qualitative requirements on risk-management would be strengthened in order to ensure that insurers appropriately monitor, manage and mitigate climate change and sustainability risks as indicated by EIOPA in an opinion. While earlier initiatives already require insurers to take into account sustainability risk in their disclosures and risk management, those initiatives do not ensure that the sustainability risks are taken into account in insurers' business strategy. Option 4 would imply integrating longer-term scenario analysis in relation to climate change in the own risk and solvency assessment. The own risk and solvency assessment aims, among others, to address risk that are not well reflected in the calculation of capital requirements and more generally risks that are hard to quantify, like risks related to climate change. By clarifying the relevance of climate change risks in the own risk and solvency assessment, Option 4 would ensure that those risks are taken into account in insurers' business strategy. The option would also aim to ensure insurers put in place internal procedures to avoid overreliance on data from past events with respect to climate change-related risks. Further details are provided in Section 1 of Annex 8. However, no changes would be made to capital requirements for sustainable investments. Instead, EIOPA would for the first time receive a legal mandate similar to the European Banking Authority's mandate in Regulation (EU) 575/2013, Article 501c, point (c). In particular, EIOPA would be asked to monitor the evidence on the riskiness of sustainable investments and, where justified, propose changes to Solvency II capital requirements.

Benefits

Option 4 would have a positive impact on policyholder protection and **some positive impact on funding for the sustainable recovery of the EU**. Stronger qualitative requirements on the management of climate and environmental risks would set incentives to reduce exposure to such risks on the asset and liability side of the balance sheet. As regards the asset side, a reduction to sustainable risks can be achieved by a shift to "green" investments. Furthermore, EIOPA's work under a new mandate may provide evidence on lower riskiness of some or all sustainable investments. In that case, the Commission would be in a position to use existing empowerments for delegated acts to

amend Solvency II capital requirements accordingly. Option 4 would also have **limited (but possibly positive) impact on the consistency and quality of supervision**. The lack of references to sustainability risks in the Solvency II Directive may result in varying approaches by supervisors to sustainability risks in the own risk and solvency assessment, in particular since sustainability risks can materialise via more traditional financial risk. Further clarification of the qualitative rules could achieve better harmonisation.

Finally, as indicated in Sub-Section 6.3.3 of the Evaluation Annex, EIOPA's insurance stress test from 2018 suggested that there is currently only a small likelihood of systemic impact of natural catastrophes on the insurance sector. However, climate change may lead to such risk becoming systemic in the future. Likewise, the materialisation of transition risks and assets exposures to entire sectors of the economy possibly "stranded" assets may translate in systemic impacts on the insurance industry. The longer-term scenario analysis required under Option 4 would lead to an earlier identification of assets that could become stranded and a reduction of transition risks for the insurance sector. Option 4 would therefore have a **positive impact on financial stability**.

Costs

In terms of **implementation costs**, insurers would have to build up the capacity to comply with new qualitative requirements on sustainable risks without the ability to benefit from lower capital requirements. This might also result in higher costs of compliance with Solvency II rules, which could be passed on to consumers by increasing insurance premiums. In the context of previous initiatives, the costs of ESG integration for small entities was estimated to range from EUR 80 000 to EUR 200 000 per year (for buying external data, doing additional internal research, engagement with companies etc.)[41]. However, insurers already need to build up such or similar capacities to comply with other legal acts, notably the disclosure requirements under Regulation (EU) 2019/2088 and amendments to the delegated acts under the Solvency II Directive[42]. The additional cost of Option 4 is therefore estimated to be significantly below that range and thus overall limited.

Option 4 would have no or very limited impact on risk sensitivity, volatility and proportionality.

Overall assessment

Effectiveness, efficiency and coherence: Option 4 would improve the incentives for sustainable investment and the management of environmental and climate risks. Option 4 is the most effective in the harmonisation of supervisory practices in the context of sustainability risks. It is of course coherent with the objectives of the European Green Deal.

Winners and losers: Policyholders would benefit from a higher level of protection due to better management of environmental and climate risks under this option. Supervisors and insurance companies would be given a clearer set of rules to ensure the integration of environmental and climate risks.

[41] See SWD(2018) 264, page 47 (link)

[42] Delegated Regulation (EU) 2021/1256 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings (OJ L 277, 2.8.2021, p. 14)

Stakeholder views: During the Commission's public consultation, respondents chose a contribution to the European Green Deal as the overall third most desirable objective for this initiative among a list of eight possible objectives. To that end, more than 70% of NGOs and public authorities supported strengthening "Pillar 2 requirements" in relation to sustainability risks.

6.1.4. Option 5: Strengthen "Pillar 2"requirements and incorporate climate change and sustainability risks in quantitative rules

Under this option, the changes to qualitative requirements as under Option 4 would be combined with lower capital requirement for green assets. In an analysis conducted in 2019, EIOPA concluded that the available evidence is not sufficient to conclude that sustainable investments are less risky than other investments[43]. Under this option, capital requirements would therefore not be fully reflective of risk characteristics, but depend on the "green" nature of investments. With all else being equal, insurers investing more in "green" assets would have a better solvency position than those with a lower share of green assets.

This option has been put forward by a few stakeholders and would be justified by the priority given to the political objective of the European Green Deal. More specifically, the option would aim to facilitate insurers' financing of the transition to carbon-neutrality even though the lack of evidence to justify such an approach would be in conflict with the primary objectives of Solvency II, namely policyholder protection and financial stability.

Benefits

Option 5 would be more effective than Options 4 (as well as the baseline) in **incentivising sustainable investments by insurers**. By proceeding to a decrease in capital requirements, the prudential cost of sustainable investments would be materially reduced. As described under Option 3, insurers would be able to hold a larger volume of sustainable investments with the same amount of regulatory capital. But insurers could also maintain their asset allocation and use capital no longer tied up otherwise. Similarly to Option 3, Option 5 would also contribute to **improving EU insurers' competitiveness** at international level. Option 5 would free-up more capital than under Option 4, which could be used, among others, to expand internationally and benefit insurers and their shareholders.

Costs

As mentioned above, such changes to capital requirements might not reflect the risk characteristics of such investments and have a **very negative impact on the risk-sensitivity of the framework**. This would also affect policyholder protection, by incentivising insurers to take much more risk, with a greater likelihood of failures of those companies. In addition, Option 5 would imply a deviation from the risk based approach whereby capital requirements are calibrated using evidence on their riskiness. This may cause supervisory authorities to pursue other tools to address the potential underestimation of the risk in the calculation of capital requirements. In such a scenario, the tools chosen by supervisory authorities are likely to differ and the option would therefore be **detrimental to the consistency and coordination of supervisory practices and thus undermine the Single Market for insurance services**.

[43] EIOPA: Opinion on Sustainability within Solvency II (EIOPA-BoS-19/241), September 2019, see in particular paragraphs 4.23 to 4.30.

Option 5 would also have a **negative impact on financial stability**. Changes to capital requirements which are neither evidence-based nor risk-based, provide wrong risk-management and investment incentives. Therefore, the option could result in too high overconfidence by investors and generate bubbles with respect to sustainable investments.

Implementation costs are expected to be limited. Although there is no available data, Option 5 would require updating IT systems so that they reflect the new risk factors for green investments, which represents a limited one-off cost. The ongoing cost would be limited as the granularity of information required for computing capital requirements would be consistent with that required for green disclosures under other EU legislations.

Finally, Option 5 would have a potential deadweight effect, as it would lead to a decrease in capital requirements with no conditionality. As such, there is no guarantee that the additional "free capital" would be used to provide further investments to the economy, and it may be an opportunity for insurers to make higher dividend distributions.

Overall assessment

Effectiveness, efficiency and coherence: Option 5 would be as effective as option 4 on the management of environmental and climate risks and it would be the most effective in incentivising sustainable investment. Moreover, changes in capital requirements could have a more immediate impact on incentivising sustainable investments than a sole reliance on the incentives stemming from rules on the own risk and solvency assessment under option 4. However, beyond investment incentives, Option 5 might result in negative impacts related to lower policyholder protection and increased financial stability risks. This option may therefore lead to economic welfare losses and contradict the two main objectives of Solvency II. Furthermore, it has to be noted that the European Green Deal states the objective of integrating climate and environmental risks into the EU prudential framework whereas it leaves open the outcome of the assessment of the suitability for green assets of capital requirements.

Winners and losers: Under Option 5, policyholders and supervisors would be losers. Although in the short run policyholders may benefit from higher return on their policies if insures take more risks, they would suffer in the long run from a lower level of protection. Supervisors would be confronted with having to address a potential underestimation of actual risk in the calculation of capital requirements. Insurers would benefit from lower capital requirements for sustainable investments – and their shareholders may hence benefit from higher dividend distributions – but also need to integrate environmental and climate risks in their own risk and solvency assessment.

Stakeholder views: In the Commission's public consultation, many more respondents objected lower capital requirements for sustainable investments (around 44%) than those that expressed support (around 29%). The share of objecting responses is particularly high among the insurance industry (around 51% objecting vs. 29% supporting) and public authorities (75% objecting vs. 13% supporting).

6.1.5. Choice of preferred options

The below tables provide a high-level summary of how the previously described options compare (note that for the sake of readability of the tables, the labels of the options have been shortened).

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1 – *Do nothing*	0	0	0	0	0	0	0	0
Option 2 – *Facilitate long-term investments in equity*	++	-	0	0	+	-	++	++
Option 3 – *Reduce capital requirements on all equities*	+++	---	0	+	-	---	--	--
Option 4 – *Strengthen "pillar 2 requirements" in relation to climate risks*	+	0[44]	-	0	+	++	+	++
Option 5 – *Integrate climate risks in both "pillar 2" and quantitative rules*	++	--	--	0	--	--	--	-

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	0	0	0
Option 2	++	+/-	+
Option 3	+++	--	+
Option 4	-	+++	+
Option 5	+/-	+/-	+/-

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

In relation to long-term equity financing, Option 2 appears to be the most suitable option. While Option 3 would be more effective in fostering long-term financing of the economy, it would be at the cost of material reductions in policyholder protection, risk sensitivity and of higher risks to financial stability. On the contrary, Option 2 would have a lower impact on investment behaviour but generate limited side effects on policyholder protection and financial stability, while having a meaningful impact[45].

In relation to the greening and the sustainable financing of the economy, while Option 5 seems to be the most effective in achieving the objective, it would have similar negative side effects on policyholder protection, risk sensitivity and financial stability. On the contrary, Option 4, while providing less incentives, would improve the way insurers incorporate sustainability and climate change risks in their underwriting and investment activities. In addition, it would have either a positive or a neutral impact on all specific objectives of this review.

The combination of Option 2 and Option 4 allows addressing the problems without generating undue costs or redundancies. Indeed, Option 2 would provide positive incentives for insurers to have a longer-term perspective when making equity investments, while Option 4 would ensure that climate change and sustainability considerations are fully incorporated in insurers' processes. Therefore, the combination

[44] While Option 4 has a positive impact on policyholder protection, it is not deemed to have a positive impact on the specific objective of risk-sensitivity as referred to in section 2.2.

[45] As a reminder, as EIOPA's set of criteria in its final Opinion differs from the ones tested as part of the data collection exercises, the estimate of the quantitative impact only provides a lower boundary of the real impact of EIOPA's proposal (and therefore of Option 2).

of the two options would facilitate insurers' contribution to the long-term and sustainable financing of the economy. Each option taken individually would however not be sufficient. Indeed, even if Option 2 can contribute to the greening of the economy, asset classes other than equity can be "green investments" but would not benefit from Option 2. Reciprocally, incorporating climate change risks in investment decisions neither guarantees that insurers refrain from making shorter-term investments (and therefore from not providing sufficiently stable funding to the real economy), nor removes obstacles to equity investments generated by prudential rules. In particular, some studies suggest that capital financing is more effective than debt financing in achieving a reduction of greenhouse gas emissions[46]. The combination of Options 2 and 4 would ensure that insurers face no prudential obstacles to the provision of long-term funding to SMEs and that they appropriately value the long-term added value of investing in green assets.

For all those reasons, the preferred options to address Problem 1 are Option 2 (Facilitate long-term investments in equity) and Option 4 (Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks).

6.2. Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies

6.2.1. Option 2: Fix all technical flaws in relation to risk sensitivity and volatility

Under this option, all changes that are technically justified and aiming to address the lack of risk-sensitivity and the excessive volatility would be adopted:

- In relation to risk sensitivity, in line with EIOPA's advice, Solvency II would be amended to ensure that the protracted low interest rate environment is appropriately reflected in capital requirements (allowance for interest rates to become negative in quantitative rules) and in the valuation of long-term insurance liabilities.
- In relation to volatility, the long-term guarantee measures (in particular, the volatility adjustment) would be amended so as to ensure that short-term volatility in credit spreads which does not reflect economic fundamentals (i.e. the part of volatility corresponding to "irrational" market movements)[47] does not result in excessive volatility in solvency ratios, but also that there is no "over-shooting effect" (i.e. that the adjustments do not result in the insurer being "better off" during crises than under normal conditions).

Benefits

Option 2 would by nature **significantly improve risk-sensitivity** of the framework **and reduce its volatility**. The integration of negative interest rates in standard formula capital requirements would imply that insurers have to address a risk, which amounts approximately € 20 billion[48]. This additional risk sensitivity would therefore **improve policyholder protection**. Option 2 could also be very efficient in enhancing the

[46] See e.g. Ralph De Haas, Alexander Popov: Finance and carbon emissions, ECB Working Paper Series, No 2318 / September 2019 (link).

[47] Solvency II distinguishes two components of credit spreads. The part corresponding economic fundamentals (risk of default and cost of downgrade) should not be compensated as this is a real risk for insurers. The rest, which corresponds to "short-term" or "irrational" market movements in spreads, could be subject to compensation in view of the long-term nature of insurance liabilities. The volatility adjustment aims to mitigate the effect of that second component of spreads on insurers' solvency.

[48] Source: Page 54 of EIOPA's impact assessment.

volatility-mitigating effect of the long-term guarantee measures for insurers located in Southern countries with higher spreads. As explained in Sub-section 6.1.1 of the Evaluation Annex, insurers' bond portfolio is subject to a Home Bias, i.e. they mainly invest in bonds of their Home Member State. When such a Member State is subject to more volatile spread movements that the rest of the Euro Areas, the sole "currency volatility adjustment" (i.e. the one applicable to all euro-denominated liabilities) is not be sufficient in mitigating spread volatility. Actually, EIOPA's proposals would allow triggering more frequently a "country-specific" adjustment, which aims to capture spread crises arising in certain Member states and not in the whole Euro area. According to EIOPA's assessment, applying retroactively the proposed amendments during the period from 2007 to 2019, insurers would have resulted in a more frequent and more significant adjustment than under current rules:

	Greece	Italy	Spain	Portugal
Number of quarters where the country adjustment is triggered under current rules	26	3	6	12
Number of quarters where the country adjustment is triggered under new rules	29	15	19	14
Average increase in the level of the adjustment between current rules and Option 2 (the higher the percentage, the higher the volatility mitigating effect)	+40%	+35%	+59%	+78%

Option 2 would also achieve reducing "overshooting effects" described in the same Sub-section of the Evaluation Annex, i.e. the fact that in some cases, under crisis situations, the volatility adjustment "over-compensates" the negative effect of increases in credit spreads, leading to an undue improvement in insurers' solvency position under stressed environments. Following EIOPA's advice, Option 2 would reduce that risk, by decreasing the level of the volatility adjustment where such risks are most likely to occur[49]. For instance, a reduction factor of 56% would be applied on average to the volatility adjustment in Netherlands to prevent this risk.

Option 2 would have a **positive impact on financial stability** for two reasons. First, by better reflecting the risk of low interest rates, it would reduce incentives for excessive search-for-yield behaviours and ensure that there is no widespread underestimation of insurers' liabilities towards policyholders. Indeed, insurers would have to set aside more capital in case of risky asset-liability management (i.e. if there is a significant duration mismatch) and the level of their liabilities towards policyholders would better reflect the low-yield environment so that there is no overestimation of insurers' own funds. In addition, by ensuring a lower volatility of the framework, Option 2 would reduce the risk of procyclical behaviours (e.g. the risk of wide-spread fire-sale of risky assets at depressed prices during down cycles).

Costs

Option 2 would overall have a **negative effect on the ability of insurers to provide long-term and sustainable financing to the European economy**. Although it would reduce volatility, Option 2 would also lead to an immediate material increase in capital requirements. According to Commission services' calculations based on EIOPA's impact assessment report:

- If applied at the end of 2019, Option 2 would lead to a decrease in solvency ratios by 13 percentage points (from 247% to 234%). This still represents a decrease in

[49] There are different sources of "overshooting", but one of them occurs when insurers' own are more sensitive to spread variations than insurers' liabilities. Option 2 would be designed in such a way that it reduces the level of the volatility adjustment in such situations.

"free surplus capital" of €15 billion for the sample of insurers which participated to the data collection exercise (decrease of approximately 5% in the surplus). If scaled up to the whole market, EIOPA estimates that the impact would be a decrease in capital surplus of EUR 18 billion.

- If applied at the end of the second quarter of 2020, when interest rates were even lower, the decrease in solvency ratio would be of 22 percentage points (from 226% to 204%), but 35 percentage points for life insurers (from 223% to 188%). This represents a decrease in available surplus for insurers which participated to the data collection exercises by EIOPA of approximately EUR 40 billion (approximately -11%), largely concentrated on life insurers. If scaled up to the whole market, EIOPA estimates that the impact would be a decrease in capital surplus of EUR 55 billion. The situation widely varies between Member state: Some countries overall benefit from the technical changes (e.g. Cyprus, Spain, Malta and Latvia), but others are materially affected (with more than 25 percentage points decrease in solvency ratios in Austria, Germany, Netherlands, and Norway).

Indeed, despite the revision of the features of the volatility adjustment, which allows improving free capital in mid-2020 by € 13 billion, as well as other technical changes improving solvency ratios[50], the reflection of negative interest rates in capital requirements and the valuation of insurance liabilities towards policyholders generates a € 81 billion decrease in available capital surplus at EEA level.

One could argue that a more stable solvency ratio could still facilitate insurers' long-term investments by allowing for more stability and foreseeability. However, the material reduction in free excess capital to make additional investments is such that it would overall be detrimental to achieving the objective of long-term sustainable financing of the European economy. This deterioration in solvency ratios would amplify the deterioration stemming from the ongoing Covid-19 crisis. Option 2 would also be **detrimental to the international competitiveness** of the European insurance industry as a lower amount of available capital offers less opportunities for insurers to expand their business internationally.

Similarly, lower volatility would on its own have a positive impact on insurers' ability to make long-term investments and to offer products with long-term guarantees. However, the material increase in capital requirements that would also stem from Option 2 would imply that insurers have a lower ability to offer life and pension insurance products with guarantees, which are still highly appreciated by insurers, as such products generate more capital requirements. Insurers would be incentivised to shift risks to policyholders (via unit-linked products) and as such would act more as asset managers rather than as "risk managers".

Overall, Option 2 would make the **framework more complex** for all insurers in the scope of Solvency II. For instance, the level of the volatility adjustment is currently determined centrally by the Commission, based on inputs provided by EIOPA. Under EIOPA's revised approach, the level of the adjustment would depend on insurers' characteristics (for instance, insurers would have to quantify the sensitivity of their assets and liabilities to changes in spread levels). EIOPA's proposals also imply that each insurer would have to establish a typology of insurance liabilities in order to determine the level of the volatility adjustment. This additional burden generates disincentives for insurers to apply this adjustment, which is easy to use under current rules, and this could

[50] + EUR 23 billion due to revised approaches to calculate the risk margin, and revised assumptions on correlations between the different risks that insurers are facing.

have a negative effect on the volatility of their solvency ratios if they are deterred from applying the new volatility adjustment. The introduction of a new method for the valuation of insurers' long-term liabilities could also increase complexity.

However, based on EIOPA's survey, depending on the specific change considered within Option 2, **implementation costs** seem to be moderate. Indeed, between 11% and 39% of respondents consider that there would be a significant one-off implementation cost, and between 7% and 33% think that there would be significant on-going costs. However, one has to note that this survey covered the largest insurers in each national market, possibly biasing the answers. Almost half of supervisory authorities estimate that they would also face significant one-off cost stemming from Option 2 (according to a survey included in EIOPA's impact assessment), and 43% of them consider that the ongoing costs would remain significantly higher than under current rules.

Option 2 would have **limited (but possibly negative) impact in improving the consistency of supervision**. The increased complexity of the framework may require more supervisory discretion and expert judgement, with possible divergences in the application of the rules. This would require EIOPA to use its "soft convergence tools" to ensure a harmonised implementation of the rules. Ability of supervisors to ensure compliance with new rules would require more on-site inspections, and the effectiveness of the supervision of new rules would therefore depend on public authorities' resources to allocate to such on-site activities.

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would be effective in improving the risk sensitivity and mitigating the volatility of the framework. It would also materially improve the level of policyholder protection and financial stability, by ensuring that the solvency position of insurers appropriately takes into account all risks that they are facing, and reflect the new low-yield environment. However, Option 2 would imply high capital cost as insurers would be subject to significantly higher capital requirements. Lower free capital available for insurers implies a lower ability to contribute to the long-term financing of the economy and makes it more challenging to offer insurance products that meet consumers' demand (in particular, long-term life and pension insurance products with a certain level of guarantees). While insurers' average solvency ratio would remain largely above what is required by quantitative rules (above 200% even if we apply Option 2)[51], they may still be under pressure by financial markets participants to issue new capital and debt instruments (for instance in order to maintain their credit rating). At this stage, and due to the low-yield environment, access to capital markets can be done at low cost, but there is no guarantee that such favourable conditions would persist in the long run. Option 2 would also make the framework more complex. By deteriorating the international competitiveness of the EU insurance industry, this would also contradict the objectives set out in the CMU Action Plan of a balanced review. Therefore, while Option 2 is fully coherent with the primary objectives of Solvency II (policyholder protection and financial stability), it conflicts with other political objectives of the Union.

[51] The actual impact on the changes on each individual changes may widely vary, also taking into account the current solvency ratios. By the end of 2019 and by mid-2020, only 10% of insurers that are reporting on a quarterly basis had a ratio, which is lower than 140%. If implemented at the end of 2019, Option 2 would not have led to any breach in solvency ratios according to EIOPA's impact assessment (p.46). If implemented during the Covid-19 crisis in mid-2020, EIOPA indicates that five life companies would not comply with their solvency capital requirements. However, none of them would breach the "minimum capital requirement", and there would therefore have no risk that they lose their license.

Winners and losers: The effect on policyholders is unclear: They would benefit from an improved level of policyholder protection, but, as explained above, would experience the negative impact of reduced access to insurance products that meet consumers' demand. In particular, insurers would be incentivized to further shift risks to policyholders, which implies that they depart from their role of "risk managers" and behave more as asset managers. Insurers would be materially affected due to the material deterioration in their solvency ratios, despite the reduced volatility of the framework stemming from Option 2. Their ability to generate return to shareholders and to expand internationally would be reduced. Finally, the situation is mixed for supervisors, which would have more comfort in the ability of the framework to protect policyholders and prevent systemic risk, but at the cost of more complexity (therefore more difficulties in ensuring an appropriate and harmonized supervision of compliance with regulatory requirement).

Stakeholder views: If we exclude those who did not express an opinion, 78% of participants to the Commission's public consultation believe that the framework does not appropriately mitigate volatility and 64% that it generates procyclical behaviours. This is the majority view among insurance stakeholders and citizens/consumers/NGOs. Views are more split among supervisory authorities where only 50% of respondents indicate that the framework does not appropriately address volatility and 38% that it generates procyclical behaviours. As regards risk sensitivity, EIOPA's technical consultations confirm that a vast majority of (insurance) stakeholders concur with the view that the current framework does not appropriately reflect the risk of negative interest rates in capital requirements, although views are more split regarding the technical approach to address this issue. Most stakeholders also believe that the review of Solvency II should lead to a balanced outcome in terms of quantitative requirements. Therefore, as Option 2 addresses the identified issues, but at the cost of significantly higher capital requirements, such an option would receive very limited if not hardly any support from stakeholders.

6.2.2. Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes

Under Option 3, the changes envisaged under Option 2 would be phased in over a certain period of time, to limit their immediate negative impact on quantitative requirements. In particular, changes on interest rates would be only progressively introduced over a period of at least 5 years. In addition, some additional measures (notably in relation to the so-called "risk margin") and small modifications to the design of the volatility adjustment (in order to slightly increase its level and simplify its functioning[52]) would be taken in order to mitigate (part of) the long-term increase in capital requirements resulting from those changes. While the final outcome depends on the effective calibration of the different parameters[53], the working assumption under this approach is that the average level of quantitative requirements at EEA level would be materially reduced in the short term (as the changes with a positive impact would be implemented immediately whereas those with a negative impact would only gradually apply). In the longer run, the level of

[52] In a nutshell, compared to EIOPA's approach, the volatility adjustment would not include a "reduction factor" to account for the features of liabilities (whether they are predictable or not). A brief outline of the reasons for removing such a factor is provided in Section 2 of Annex 8. Removing this reduction factor would reduce insurers' liabilities towards policyholders and therefore release between € 5-10 billion of additional "free capital".

[53] In particular, the Commission services are considering implementing the amendments on interest rate risk in a slightly different manner from what EIOPA proposed, so that the approach to stressing the risk free interest rate curve is more in line with the approach used to derive the regular risk free interest rate curve. For the purpose of quantifying the impact of Option 3, this revised approach will be taken into account.

quantitative requirements at EEA level would remain lower than under current rules, although the framework would allow for a better risk attribution. The extent of this decrease depends on market conditions.

Benefits

Option 3 would have a **positive impact on the ability of insurers to provide long-term and sustainable financing to the European economy over time**. The reduced volatility of the framework would incentivise long-termism in underwriting and investment decisions by insurers. In addition, as the overall impact of the review in terms of quantitative requirements would be more than balanced at EU level (insurers' own funds in excess of capital requirements would increase[54]), there would be limited impact on insurers' ability invest in the real economy, and this limited impact would in any case not offset the positive effect of reduced volatility[55]. In addition, the progressive implementation of the changes with very negative impact would actually lead in the short term to a very significant improvement in the solvency position of insurers, which releases capital (up to € 90 billion of additional capital resources in excess of capital requirements) to provide financing to the economic recovery of the EU. However, there is no guarantee that such capital relief is not used by insurers to reduce their level of capital by making additional dividend distributions or proceeding to share buy-backs.

Taking into account the incremental implementation on the changes on interest rates, the insurance sector would start with an increase in capital resources in excess of capital requirements of up to € 90 billion[56] immediately after the review compared to capital resources under current rules (assuming similar economic conditions as at the end of second quarter of 2020). While the sector's capital resources would increase during the most important period for the post-Covid economic recovery, this increase in capital resources would reduce during every year of the phasing in period. At the end of the phasing in period, Option 3 would still maintain an estimated increase in capital resources by € 30 billion in an economic environment similar to that at end of 2019. If the economic environment is similar to that at the end of mid-2020, Options 3 would lead to a € 16 billion increase in capital resources in excess of capital requirements (whereas under EIOPA's advice – as described in Option 2 – capital resources in excess of capital requirements would decrease by € 55 billion)[57].

Option 3 would by nature **significantly mitigate undue volatility**. It would also **improve risk sensitivity, but only in the long term,** in view of the phasing-in approach to the implementation of the changes. Therefore, in the short term, the improvement in risk-sensitivity would remain very limited. Moreover, the additional "counterbalancing" measures (e.g. revision of some parameters underlying the risk margin calculation) that

[54] It is more difficult to assess the impact in terms of solvency ratios. However, the Commission services estimate that Option 3 would not change solvency ratios by more than a few percentage points on average at EEU level

[55] This is different from Option 2 where the increase in capital requirements is significant, and this impact offsets the benefit of mitigated volatility.

[56] See next table for further details. Under market conditions similar to those at the end of the second quarter of 2020, the overall impact of the proposed changes would be +8 billion for the sample. By phasing in the changes on interest rates which will eventually increase capital requirement by € 73 billion, Option 3 would generate a short-term capital relief of +€ 81 billion for the sample. When extrapolating this figure to the whole EU market, we end up with a capital relief of more than € 90 billion. Source: Commission services' calculations on the basis of data and analysis provided by EIOPA.

[57] Actually, by the end of the phasing-in period, the capital relief is expected to be even higher, as the volume of generally older insurance policies with high guaranteed rates will eventually be replaced by newer business, which typically has less generous guarantees. This implies that when fully implemented, the amendments on interest rates will be less impactful than if they were fully applied immediately.

would be taken in order to mitigate the negative impact from the other changes aimed to improve risk sensitivity would lead to a slightly lower level of prudence compared to Option 2. In other words, Option 3 would be less conservative than Option 2 in very targeted areas. Those changes would be justified by the greater emphasis on the objective of preserving international competitiveness of the European insurance industry than in Option 2[58], even if that leads to a slightly lower level of policyholder protection in comparison with Option 2. Still, the revised calibrations would remain justified to a certain extent by quantitative evidence[59], although the limited robustness of that evidence could also have justified not lowering some parameters. In addition, it should be underlined that Option 3 is a clear improvement in policyholder protection and risk sensitivity in comparison with the baseline scenario. While the overall level capital requirements would decrease compared to the baseline, Option 3 allows for a better risk attribution by acknowledging the materiality of risks in relation to interest rates, while adapting other components of the framework where it could be argued that the current set of rules is overly prudent.

Finally, Option 3 would have a **positive impact on financial stability**, although less immediate and less material than in Option 2. Indeed, the choice of making "compensating changes" to counterbalance the negative impact of the amendments stemming from Option 2 would make the disincentives against excessive risk taking less effective than under the previous option, while still having a positive impact compared to the *status quo* (baseline – Option 1). In addition, the phasing-in of the changes on risk sensitivity implies that financial stability risks remain until the amendments are fully implemented (possibility to understate the impact of the low-yield environment in the short term). Still, in the long run, the preservation of financial stability would be improved, all the more that the reduction in the volatility of the framework would avoid procyclical behaviours.

In summary, the below table provides the comparative impacts of Options 2 and 3, **for the sample** of insurers which participated to the data collection exercise by EIOPA. Note that the previous blue box provided the estimated cumulative impact of all changes for **the whole market.**

[58] As a reminder, Option 2 would have a very negative effect on insurers' international competitiveness.

[59] In particular, the protracted low yield environment could justify a decrease in the assumption of "cost-of-capital rate" which is an input to the calculation of the risk margin, as also requested by the insurance industry. This parameter is currently set at 6% but has not been revised since 2014. The low-yield environment makes it reasonable to decrease this factor down to 5%. In view of the limited evidence, a further decrease would however not be justified, and has therefore been discarded. Similarly, EIOPA introduces a new "lambda factor" in the calculation of the risk margin which aims at reducing the size of this item for long-term business. However, EIOPA introduces a cap to the extent of the reduction (50% maximum). However, EIOPA does not provide concrete justification for this cap, which is penalizing long-term businesses. Therefore, the Commission services recommend not introducing such a cap..

Driver	Impact assessment of Option 2 and Option 3 (in EUR billion) *Negative figures mean that insurers' capital resources deteriorate*					
	Fourth quarter of 2019			Second quarter of 2020		
	Option 2	Option 3	Difference	Option 2	Option 3	Difference
Changes on interest rates	-55	-48	7	-81	-73	8
Volatility adjustment	16	28	12	13	45	29
Risk margin	16	28	12	18	30	12
Other	8	8	-/-	10	10	-/-
Total	**- 15**	**+ 16**	**+ 31**	**- 40**	**+ 8**	**+ 48**

Based on those figures, we can note that on average, there would be no immediate need for capital increases by insurers. While the quantitative impact would remain contained, Option 3 would lead to a material improvement compared to the baseline, by allowing for a better risk attribution (i.e. by laying more emphasis on interest rate risk, like in Option 2). The "compensating measures", which are further explained in Section 3 of Annex 8, are not materially affecting risk sensitivity or financial stability, as they can be technically justified to a certain extent and imply removing layers of prudence in other areas of the current framework, which may be deemed excessive. The Commission services have not considered changes, which would not be justified by any quantitative evidence, as this would go against the primary objective of improving risk sensitivity. In conclusion, the difference with Option 2 in terms of improved risk sensitivity and financial stability is deemed limited in the long run (once the full impact of the changes are implemented).

Costs

Like Option 2, Option 3 would make the **framework more complex for all insurers**. However, as the volatility adjustment would be simplified in comparison with Option 2, Option 3 would have a less negative impact than Option 2. The "compensating" measures introduced in Option 3 may also slightly increase implementation costs compared to Option 2, although the difference is expected to be minimal. Indeed, the approach during the transitional period would be similar to the one during the permanent regime (e.g. instead of taking the full impact of the negative interest rates in the first year, insurers would only take one fifth of that impact; the next year insurers would take two fifths, and so on). Finally, the phasing-in period implies updating information system every year until the fully-fledged changes are made. Therefore Option 3 would generate moderate **implementation costs**.

Like Option 2, Option 3 would have **limited (but possibly negative) impact in improving the consistency of supervision**, due to the increased complexity of the changes introduced and the need to maintain consistency as regards the timing of the gradual adjustments. As Option 3 would also streamline some of the technical adjustments (which are deemed too burdensome while bringing limited added value from a technical standpoint[60]), it would be slightly less complex than Option 2, and the risk of diverging supervisory practices would be slightly lower.

Finally, as explained above, Option 3 postpones to the medium term the appropriate improvement on risk sensitivity and financial stability as the amendments with a negative

[60] See Section 2 of Annex 8 to have further details on the streamlining of the volatility adjustment.

impact would only be gradually implemented. Therefore, in the short term, the ability of Option 3 to address the problem of insufficient risk sensitivity is limited. In addition, the moderate but negative effect of Option 3 on long-term solvency ratios is more than offset by the benefits in terms of reduced volatility. Therefore, overall, Option 3 does not have a negative effect on long-term financing and on international competitiveness.

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would be effective in improving the risk sensitivity and in mitigating the volatility of the framework. It would be also more efficient than Option 2, by avoiding significantly negative impact on insurers' competitiveness and on financial stability, and by smoothing any remaining negative impact over time. While policyholder protection would be slightly lower than in Option 2, it would be much improved compared to the baseline. In addition, the identified adaptations compared to Option 2 would still have a technical basis as modifications that could not be backed by any quantitative evidence have been discarded. As such, Option 3 is broadly coherent with the primary objectives of Solvency II (policyholder protection and financial stability) and would not hinder – and actually would even contribute to – other policy objectives such as facilitating the long-term and sustainable financing of the European economy.

Winners and losers: Policyholder protection would be improved. While the level of policyholder protection would be slightly lower than in Option 2, Option 3 would largely preserve insurers' ability to supply insurance products with guarantees that meet consumer demands. Therefore, the benefits for consumers has to be weighed against the slight reduction in policyholder protection compared to Option 2. Insurers would benefit from with mitigated volatility and greater ability to make long-term decisions, despite the tighter rules on interest rates (which are however largely counterbalanced by other adaptations). Still, they would have to cope with a more complex framework. The potential moderate increase in overall requirements may also reduce insurers' ability to make dividend distributions, although insurers' solvency ratios would remain on average above 200% under Option 3. Finally, the supervision of compliance with regulatory requirements would be more complex than under current rules, also taking into account that during the "transitional phase" the actual risks may still not be fully measures in quantitative rules with limited ability to intervene in case of concern.

Stakeholder views: As already explained when discussing Option 2, a majority of stakeholders would support an approach aiming to mitigate volatility and to improve risk sensitivity, while avoiding material increases in capital requirements. Therefore, among the three options, Option 3 would probably receive greatest support from stakeholders. Note that insurers would call for more radical changes to the framework to reduce the level of capital requirements and improve their competitiveness. However, this would go against the primary objective of policyholder protection, and such changes would not be justified. Supervisory authorities would have to cope with a more robust but more complex framework, and they would have less assurance than in Option 2 that the framework is achieving an appropriate level of policyholder protection. Still, most supervisors support the principle of a "phasing-in" although they would not support a too long transitional period. The "accommodating measures" (compared to Option 2) are consistent with various stakeholders' requests (insurance industry, several public authorities, etc.), although they have not been put forward by EIOPA in its final opinion.

6.2.3. Choice of the preferred option

The below tables provides a high-level summary of how the previously described options compare (note that for the sake of readability of the tables, the labels of the Options have been shortened).

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1 –*Do nothing*	0	0	0	0	0	0	0	0
Option 2 – *Fix all technical flaws*	--	+++	+++	-	-	+++	---	---
Option 3 – *Address issues of risk sensitivity/volatility while balancing the cumulative effect*	+++	++	+++	-	-	++	++	++

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	--	+++	+/-
Option 3	+	++	-

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect **0** = no effect - = Slightly negative -- = Negative --- = very negative

Option 2 would be the most effective in addressing issues related to insufficient risk sensitivity and excessive volatility. The benefits in terms of policyholder protection and financial stability would however be compensated by the highly negative impact on insurers' competitiveness and ability to provide long-term sustainable financing to the economy. Therefore, there is a trade-off to be made between Option 2 that achieves policyholder protection and Option 3, which, while being less effective in policyholder protection than Option 2, would not materially harm any other specific objective. In view of the high political priority of the review to facilitate insurers' contributions to the completion of the CMU and the European Green Deal, Option 3 is deemed more appropriate in achieving the right balance between technical robustness, policyholder protection, and the preservation of insurers' ability to finance the economic recovery.

The preferred option to address Problem 2 is Option 3 (Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes)[61].

6.3. Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers

6.3.1. Option 2: Exclude a significant number of firms from Solvency II and enhance the proportionality principle within Solvency II

This option follows EIOPA's advice, which proposes a significant increase in the size thresholds below which insurers are excluded from the scope of mandatory application of

[61] Please refer to Sections 2 and 3 of Annex 8 for further details on the approach to reducing volatility and to ensuring a "balanced" approach to the review in terms of capital requirements.

Solvency II. Therefore, a number of insurers currently in the scope of the European framework would no longer be subject to this regime, but instead to national-specific regimes. More precisely, Option 2 would imply:

- doubling the threshold on insurers' liabilities towards policyholders: from € 25 million to € 50 million;
- leaving the discretion for Member States to set the threshold on gross written premiums between € 5 million (current threshold) and € 25 million[62].

The rationale behind EIOPA's approach is to consider that insurers' liabilities towards policyholders are a first line of defense of policyholder protection. Therefore, a change in the threshold in this area needs to be carefully considered. On the contrary, EIOPA is of the view that there is less risk in granting more flexibility to Member States in relation to business revenues (gross-written premiums) which is not a measurement of risk exposure.

Furthermore, EOPA advises to set up a preferential treatment, in terms of proportionality, for firms complying with a list of criteria defined in the framework. Based on seven criteria[63] (only one of them related to size), "low-risk profile" insurers would benefit from automatic application of several Solvency II proportionality measures, which would be clearly specified in the legislation. Additional simplifications would also apply to certain types of insurers, notably insurance captives (i.e. insurance companies established by an industrial or commercial group to provide coverage for itself).

Finally, Option 2 would mandate EIOPA to publish an annual report on the application of the proportionality principle across the EU.

Benefits

By reducing the mandatory scope of application of Solvency II, Option 2 would result in a material reduction in compliance and capital costs for insurers that are newly excluded, as it is expected that national rules are less stringent in terms of reporting rules[64]. Based on EIOPA's impact assessment, 228 out of 2525 EEA insurance companies (i.e. 9% of all insurers that are currently in the scope of Solvency II) would be excluded from the scope of the European framework under Option 2. It should be noted that as the threshold related to revenues is subject to national discretion up to € 25 million, Member States, would be able to retain a lower limit (or even apply Solvency II to all insurers, as it is currently the case in thirteen Member States). Assuming that Member States that currently apply Solvency II to all insurers do not change their approach, only up to 180 companies (i.e. 7% of all EEA insurers that are currently subject to Solvency II) would actually be excluded in accordance with Option 2. The wider discretion given to Member States in relation to the scope of Solvency II allows taking into account national specificities, notably the relative size of each national market.

EIOPA's impact assessment also suggests that the criteria to define "low-risk profile" insurers would allow capturing 407 companies, which represent 16% of EEA insurers (0.5% of the life market share in terms of insurers' liabilities and 1.8% of the non-life

[62] Member States have full flexibility regarding the supervisory regime applicable to insurers below the thresholds set out in the Solvency II Directive. Therefore, they can apply Solvency II at national level beyond the minimum scope defined by the Directive. As a result, the discretion proposed by EIOPA in relation to the gross-written premium threshold would also concern insurers with gross written premiums of less than € 5 million. In practice, EIOPA's recommendation is equivalent to simply setting the gross written premium threshold to the highest boundary of € 25 million (multiplication by 5 of this threshold).

[63] See page 48 and 49 of EIOPA's Opinion on the 2020 Review of Solvency II.

[64] For instance, seven Member States apply Solvency II principles but with some exemptions, another six Member States apply Solvency I, and five a regime, which is different from Solvency II and Solvency I.

market share in terms of gross written premiums). However, those estimates do not take into account the reduction in the number of firms subject to Solvency II due to the increase in the thresholds of exclusions from the scope of mandatory application of the Directive. Assuming that the 228 firms that would be excluded from Solvency II would also be low-risk profile, the minimum number of insurers, which would meet the criteria to be considered as "low-risk profile" would be 179 (instead of 407), representing 7% of current total Solvency II insurers.

For those insurers that are deemed "low-risk profile", the regulatory burden would be lower, notably, in terms of governance and reporting requirements (lower frequency of submission of the ORSA report – two years instead of one –, frequency of submission of regular supervisory report by default set at three years). In addition, given the difficulties to capture all features of "low-risk profile" insurers through seven criteria only, EIOPA proposes that other insurers, not compliant with those criteria, could still be granted identical benefits in terms of proportionality when they get an ad-hoc authorisation from their NSAs. Finally, EIOPA proposes to introduce some further simplifications in relation to quantitative requirements, notably the possibility to reduce the frequency of calculation of capital requirements in relation to risks that are deemed immaterial. Therefore the implementation of Option 2 would certainly **increase the proportionality of prudential rules** in order to remove unnecessary and unjustified administrative burden and compliance costs, notably for low-risk profile insurers and those other companies whose nature, scale and complexity of the undertaken risks are deemed limited.

The enhancement of the proportionality principle and the associated reduction of undue administrative and compliance costs would improve **EU insurers' competitiveness.** Indeed, proportionality would not only depend on size but on the nature, scale and complexity of the risks of each insurer. Therefore, even larger insurers, which conduct international business may benefit from some proportionality measures and from the associated reduction in compliance costs.

Specific proportionality measures in relation to captive insurers would also be introduced. Captive insurance is an alternative to self-insurance in which a corporate group establishes an insurance company to provide coverage for itself. The main purpose of establishing a captive insurer is to avoid relying on traditional commercial insurance companies, which may have volatile pricing and may not meet the specific needs of the corporate group. By creating its own insurance company, the corporate group can reduce its risk management costs, insure difficult risks, have direct access to reinsurance markets, and increase cash flows. Implementing more proportionate rules in relation to captive insurance would facilitate – and therefore incentivise – businesses to establish such firms. This might allow a more efficient risk management by industrial and commercial groups, and **improve the resilience of economic activities against systemic events**, which may not always be appropriately covered by private insurers' product offering (for instance, captives may be used as a risk management tool against pandemic events if private insurers' supply against such events proves to be insufficient).

It is not possible to have a clear assessment as to whether Option 2 would have a positive impact on the long-term financing and the greening of the European economy. The conclusion actually depends on the national framework to which insurers excluded from Solvency II would be subject. If the national framework is close to the former Solvency I regime, then it is expected that insurers are not subject to capital requirements on their investments, and would therefore have less constraints when taking investment risks. However, national frameworks may also include limits on investments in certain asset

classes, which could then have a negative effect on insurers' ability to invest in the real economy. As for those insurers, which would remain in the scope of Solvency II, the reduced compliance costs would improve the long-term profitability and capital resources. Higher levels of own funds may facilitate more risk taking (and therefore more ability to invest in riskier asset classes, such as equities).

Costs

Insurers that would be newly excluded from Solvency II would possibly face material one-off costs due to the need to change all reporting and IT systems. In any case, insurers may always choose to continue being subject to Solvency II, so switching costs could always be avoided. This may also imply sunk costs as those small companies, which would be newly excluded from the framework have probably incurred significant costs to comply with Solvency II requirements. However, as explained above, in the longer run, they would probably face lower ongoing compliance costs. Insurers that are not in the scope of mandatory application of Solvency II (i.e. those below the exclusion thresholds) may still request licensing under Solvency II, which is needed in order to operate cross-border. For those insurers, the extension of thresholds would have no direct financial or economic impact.

Nevertheless, a negative indirect impact on the competitiveness of the small and medium sized insurers that continue under the Solvency II scope cannot be ruled out. The considerable extension in revenues thresholds would make it more likely that insurers may have to compete in another Member State with other European companies of larger size but which are excluded from the application of Solvency II. For example, let us assume that a country A sets the exclusion threshold at € 25 million whereas country B keeps it at the current € 5 million. An insurer of country B with € 6 million gross written premiums would be subject to Solvency II, and if it is operating in country A, would have to compete with local insurers that may be up to four times as big as itself but which would still not face the compliance costs of Solvency II. This disadvantage, in terms of competitiveness, for the cross border insurers in country A may became a barrier to the entrance of other European providers to the Member State with higher thresholds in revenues, leading to unintended effects in the global competitiveness of the insurance sector.

For those insurers, which remain in the scope of Solvency II but are eligible to be recognized as low-risk profile, there would be some one-off **implementation costs** related to the submission of the application to benefit from the automatic proportionality measures[65]. The likely high number of applications would generate significant implementation costs for public authorities in the short term, as they would have to assess the validity of all applications.

However, the numerous companies that would be excluded from Solvency II (up to 9% of all insurers currently in the scope of Solvency II) would no longer submit data to EIOPA. Therefore, the latter would have less possibilities to monitor on a sector-wide basis the trends and potential build-up of systemic risk in the insurance sector. Hence, Option 2 may slightly deteriorate the ability of the framework to prevent systemic risk, which would more heavily depend on the quality of national supervision and the robustness of the national prudential regimes.

[65] The cost of the application would however be probably significantly lower than the long-term gain in terms of reduced regulatory burden. However, should such costs prove to outweigh the benefits, an insurer has no obligation to submit an application (in which case it would still fully apply Solvency II.

Finally, Option 2 would have a **negative impact on the level of policyholder protection**, in terms of both quantitative requirements and transparency. National quantitative rules are expected to be less stringent than EU ones, and this implies a higher risk of insurance failures. Similarly, public disclosure under national rules may be less strict than under Solvency II, and policyholders of insurers which would be newly excluded from Solvency II would no longer benefit from the high quality and granularity of information contained in the annual reports by insurers on their solvency and financial condition (SFCR). The extension of the scope of insurers, which would be subject to the patchwork of national regimes would result in an **overall decrease in risk sensitivity** (for instance, Solvency I which is applied in six Member States to insurers excluded from Solvency II is not a risk-based framework). It would also automatically have a **negative effect on the consistency and coordination of insurance supervision across the EU**.

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would result in a clear reduction of compliance costs for insurers and would achieve a significant simplification of the framework. The Commission services have requested some industry stakeholders to assess the extent of the reduction of compliance costs stemming from EIOPA's advice. Due to the time constraints, stakeholders could only provide partial information. Thus, some of the proportionality measures envisaged in Option 2 (namely the reduced frequency of the ORSA report, the reduced frequency of mandatory review of internal written policies and the possibility for the same person to cumulate several "key functions" in a firm) could allow saving up to one FTE[66].

The annual report to be published by EIOPA on proportionality would foster transparency on the state of play and would enhance peer pressure so that all public authorities would have to effectively implement the proportionality principle. Therefore, Option 2, would materially reduce the administrative burden and the cost of compliance for the vast majority of small and medium companies in scope of the European framework, improving the efficiency of many insurers and therefore, contributing to preserving the competitiveness of the European insurance industry. However, due to a very significant increase in exclusion thresholds, Option 2 would largely achieve proportionality by reducing the scope of the European framework, with potential negative impact on the level-playing field in the European market. Option 2 would also be coherent with the Better Regulation agenda to reduce undue administrative costs.

Winners and losers: The insurance sector would take advantage from clearer rules on the application of the principle of proportionality, as it would not only apply to the smallest insurers, but also to those that are larger but have a low-risk profile (because they either meet the criteria or are granted *ad hoc* approval by their supervisory authority). Notably, small and less risky companies would face lower administrative burden either because they are excluded from the scope of the Directive or because they are deemed "low-risk profile" insurers. Losers would be the policyholders of those insurers that are no longer subject to Solvency II, as the level of protection could be lower and consumers would probably benefit from less transparency. Supervisory authorities would also be losers to a certain extent, as they would no longer have the wide margin of discretion that they currently have in applying the rules. The new proportionality measures would also imply for them less information submitted through narrative reporting. In addition, the wider scope of insurers subject to national regimes would imply that supervisors would face more difficulties in comparing financial data based on two different sets of risk metrics

[66] Source: AMICE. Of course, the actual figure depends on the size of the company and the proportionality measures it is applying currently.

(due to the coexistence of a European and a national regime). At European level, EIOPA would also see a reduction of the data collected and in the numbers of firms under its remit. Also, there would be a certain fragmentation of the Single Market for insurance firms.

Stakeholder views: As part of EIOPA's consultation activities, insurance stakeholders largely welcomed the proposed extension of the exclusion thresholds as envisaged in Option 2, although some national insurance associations expressed concerns for the level-playing field. In relation to proportionality within Solvency II, stakeholders were of the view that EIOPA's proposal fell short of expectation, notably in relation to reporting and disclosure.

6.3.2. Option 3: Give priority to enhancing the proportionality principle within to Solvency II and make a smaller change to the exclusion thresholds

Option 3 would follow a similar approach as Option 2, but with the following differences (deviations from EIOPA's advice):

- In relation to the scope of Solvency II, the increase in exclusion thresholds related to gross written premiums would be lower (multiplication by three instead of five)
- In relation to proportionality within Solvency II, the eligibility criteria to be classified as low-risk profile insurer would be slightly streamlined compared to Option 2[67], and those insurers would benefit from additional proportionality measures in relation to public disclosure. Notably, a full SFCR would only be required every other three years, whereas only a simplified report with limited "narrative" parts would have to be published on a yearly basis. The proportionality measures of Option 2, including in relation to supervisory reporting, would also be granted to low-risk profile insurers.

Therefore, under Option 3, Solvency II would remain applicable to more firms than in Option 2, and a larger number of Solvency II firms would also be presumably classified as low-risk profile insurers. Those low-risk insurers would benefit from the automatic application of all Solvency II proportionality measures, which would be further expanded compared to Option 2.

Benefits

According to EIOPA's impact assessment, Option 3 would result in the exclusion from scope of Solvency II of up to **186 companies** out of 2525 entities (7 % of insurers that are currently applying Solvency II). Assuming that Member States, which currently apply Solvency II to all insurers do not change their approach, only up to 142 companies (i.e. 6% of all EEA insurers that are currently subject to Solvency II) would actually be excluded in accordance with Option 3.

Consequently, a larger number of firms than in Option 2 would remain in the scope of Solvency II. This also implies that more insurers than in Option 2 could take advantage of the proportionality measures identified by EIOPA, provided that they comply with the criteria to be classified as low-risk profile. Based on EIOPA's impact assessment, the reduced list of criteria compared to Option 2 would imply that approximately 435 insurers (i.e. 17% of the European market) would be eligible to automatic proportionality

[67] For the purpose of this impact assessment, one criterion would be dropped, in relation to the comparison of investment returns with average guaranteed rates for life business. The reason for dropping this threshold is the difficulty to actually have a meaningful and comparable approach to measure such rates.

under Option 3[68]. However, EIOPA's figures do not take into account a potential change in the exclusion thresholds. Assuming that the 186 firms that would be excluded from Solvency II would also be low-risk profile, the minimum number of insurers, which would meet the criteria to be considered as "low-risk profile" would be 249 (instead of 435), representing 10% of current total Solvency II insurers.

Therefore, Option 3 would **increase proportionality and remove unnecessary and unjustified administrative burden and compliance costs**, in a different manner than in Option 2. Indeed, the number of firms that are excluded from the scope of Solvency II under Option 3 is slightly lower than under Option 2. Nevertheless, the scope of insurers that would be eligible to automatic proportionality would be larger, as well as the number of proportionality measures (indeed, additional proportionality measures in relation to supervisory disclosure would be granted under Option 3). Option 3 would therefore further reduce compliance costs of those insurers, which remain in the scope of Solvency II than Option 2. Note also that insurers can always decide remaining in the scope of Solvency II even if they are not in the scope of mandatory application of the Directive. For this reason, if a national framework proves to be more burdensome than Solvency II, insurers would still have the possibility to continue applying Solvency II.

By further enhancing the proportionality principle and the associated reduction of undue administrative and compliance costs for insurers in the scope of Solvency II, Option 3 would be more effective in improving **EU insurers' competitiveness** than Option 2. Finally, like under Option 2, proportionality measures in relation to captive insurers could incentivise businesses to establish such firms. This may allow a more efficient risk management by industrial and commercial groups, and **improve the resilience of economic activities against systemic events** which may not always be appropriately covered by private insurers' product offering (for instance, captives may be used as a risk management tool against pandemic events if private insurers' supply against such events proves to be insufficient).

For the same reasons as in Option 2, it is not possible to assess the impact of this Option on insurers' ability to provide long-term and green financing of the economy.

Costs

By slightly reducing the number of insurers that would be newly excluded from Solvency II (compared to Option 2), Option 3 would have a **less negative effect on the consistency of insurance supervision and level-playing field than Option 2**. Option 3 would indeed ensure that only policyholders of smallest and less risky insurers would be left without the minimum layers of protection of the European framework. Since the size thresholds would be subject to a lower increase than under Option 2, situations where an insurer operating cross-border (and therefore subject to Solvency II) would have to compete on a national market with a larger insurer that is not in the scope of Solvency II would concern less firms. Therefore fair competition within the EU would be better preserved than under Option 2.

Likewise, as more insurers would continue applying Solvency II, Option 3 would be more prudent than Option 2. Therefore, it would raise less financial stability risks, as the share of insurers that would no longer be in the scope of the European monitoring by EIOPA would only represent up to 7.5% only of the European market (i.e. 0.07% of gross written premiums and 0.06% of insurers' liabilities towards policyholders), according to EIOPA's impact assessment.

[68] Calculations derived from EIOPA's background document on the Impact Assessment.

Finally, **implementation costs would be similar to Option 2,** although sunk costs and one-off costs of transitioning from Solvency II to national regimes would be lower under Option 3 (as less firms would be excluded from the mandatory scope of Solvency II). For those insurers which would have been excluded from Solvency II under Option 2 but remain in its scope under Option 3, compliance costs would be higher. Finally, insurers benefiting from automatic proportionality would be higher than in Option 2 and the additional proportionality measure of lower frequency of publication of "full" SFCR would make compliance costs lower than in Option 2.

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would be more effective in enhancing proportionality and improving EU insurers' competitiveness, while the impact of excluding some firms from Solvency II on policyholder protection and on financial stability would be lower than under Option 2. Option 3 would also reduce the risk of uneven level-playing field (as the extent of Member States' discretion to apply or not apply Solvency II at national level to insurers that are below the exclusion thresholds would be lower in Option 3 than under Option 2[69]). For those reasons, Option 3 is a more efficient approach than Option 2 to enhance proportionality with limited side effects on other objectives. Option 3 would be more coherent with the Better Regulation agenda than Option 2, as it would further expand proportionality measures and eligible entities than what EIOPA proposed, notably in relation to disclosure, which is an area where insurers expect alleviations of regulatory burden.

Winners and losers: Policyholders would be less losers than in Option 2, as a larger number of them would still benefit from the high level of protection provided by Solvency II. Lower compliance costs for insurers in the scope of Solvency II would also imply higher ability for insurers to innovate and supply policyholders with a well-diversified range of insurance products. The reduced disclosure would not necessarily affect policyholders, as the "light" version of the SFCR, which would be published when the full report is not required would still include targeted information towards consumers. However, other specialised stakeholders (financial markets participants, analysts, etc.) would not have the same level of information as in Option 2 for low-risk insurers that are in the scope of solvency II. The impact of insurers is more mixed. For those insurers that would be excluded from Solvency II under Option 2 but would remain in the scope under Option 3, the regulatory burden would be higher and those insurers could be seen as losers. However, under Option 3, more insurers in the scope of Solvency II would be classified as low-risk profile and all low-risk profile insurers would benefit from more proportionality measures, and as such, they gain. Supervisors would also be slightly more losers than in Option 2 as the information disclosed on a yearly basis would be reduced when the "full" SFCR is not required.

Stakeholder views: As part of the qualitative comments received during the Commission's public consultation, many stakeholders highlighted the need to adopt proportionality measures in relation to reporting and disclosure. The lower frequency of the SFCR was mentioned by several insurance associations. Similarly, many respondents also called for a less strict list of criteria[70] to be classified as low-risk profile. Option 3, which fine-tunes EIOPA's criteria, would therefore partly address their requests. As

[69] Exclusion threshold on gross written premiums would indeed be set at EUR 15 million under Option 3, but at EUR 25 million under Option 2.

[70] Some criteria were deemed too restrictive (size, non-traditional investments) or unjustified (cross border business) by stakeholders. Any relaxation of these criteria would naturally lead to that more insurers could comply with the conditions to be considered as low-risk profile insurers.

regards the scope of application of Solvency II, mutual insurers and mutual insurance associations called for an increase in thresholds that goes beyond what EIOPA envisaged (i.e. raising the threshold of gross written premiums to € 50 billion). For those insurers, Option 3 would therefore not meet their expectations, although most mutual insurers would probably meet the shorter list of classification criteria for low-risk profile insurers included in this option and would therefore benefit from automatic proportionality.

6.3.3. Choice of the preferred option

The below tables provides a high-level summary of how the previously described options compare (note that for the sake of readability of the tables, the labels of the Options have been shortened).

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1 – *Do nothing*	0	0	0	0	0	0	**0**	**0**
Option 2 – *Exclude a significant number of firms & enhance proportionality*	0	-	0	++	--	--	+	+
Option 3 – *Give priority to enhancing proportionality within Solvency II*	0	-	0	+++	-	-	++	+

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	+++	--	--
Option 3	++	-	-

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

	Firms that would be newly excluded from Solvency II		Firms that would remain in Solvency II but would be classified as low-risk profile		Total number of firms benefiting from a change to the framework	
	Maximum number	Share of current total Solvency II insurers	Minimum Number	Share of current total Solvency II insurers	Expected Number	Share of current total Solvency II insurers
Option 1	/	/	/	/	/	/
Option 2	228	9%	179	7%	407	16%
Option 3	186	7%	249	10%	435	17%

Option 2 would be the most effective in achieving proportionality by simply waiving the mandatory application of Solvency II to the largest number of firms from the European framework. However, this would be to the detriment of policyholders (whose level of protection could be lower if national frameworks are not risk based or rely on a lower level of prudence than Solvency II). It would also affect supervisors (which would lose supervisory discretion compared to current rules, and would face a reduction in the number of data received from insurers due to the lower frequencies of reporting for low-risk profile insurers). Option 2 would also have a negative impact on other specific objectives. Option 3, while being less effective than option 2 (although it enhances proportionality within Solvency II), would be more cost efficient as the negative side

effects on other stakeholders or other specific objectives (consistency of supervision, level-playing field and financial stability) would be lower than under Option 2. In addition, one can note that in total, Option 3 would allow covering a larger number of firms in the scope of proportionality (either via an exclusion from the mandatory scope of application of Solvency II or the application of automatic proportionality within Solvency II).

Option 3 would therefore be the most efficient Option, considering the large acknowledgement among all types of stakeholders that there is a need to simplify Solvency II for smaller and less complex insurers. In other words, Option 3 would ensure that most policyholders remain protected by the Solvency II framework while creating a regime for low-risk profile insurers that is more fit in terms of compliance and regulatory costs. Based on EIOPA's inputs and the feedback from the industry, the Commission identified a series of proportionality and simplification measures which would be part of the implementation of Option 3. The main measures are described in Annex 4.

The preferred option to address Problem 3 is Option 3 (Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.).

6.4. Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures

The options presented in this section address problem drivers underlying the core problem of insufficient policyholder protection, including in the case of an insurer's failure. They encompass different sets of measures along a continuum of supervision, recovery, resolution and insolvency. Therefore, although they are complementary in achieving the objective of enhanced policyholder protection, they remain different dimensions for which each set of measures should be discussed and assessed on its own merits. Section 6.4.4 assesses how the respective related costs and benefits interact.

6.4.1. Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision

Under Option 2, the legal framework would be clarified and strengthened so as to ensure more quality and convergence of supervision, in particular in relation to cross-border and group supervision, in line with EIOPA's general approach. In relation to group supervision, Option 2 would imply: (i) strengthening and harmonising supervisory powers including when their headquarter is in a third country or when the parent company is a non-regulated entity[71], and (ii) clarifying prudential rules on capital requirements and risk management which are subject to diverging interpretations by Member States[72]. In relation to cross-border supervision, more requirements concerning

[71] Proposal includes better framing of cases where a national authority may completely waive group supervision (under the control of EIOPA), clarifying powers over unregulated parent companies of a group, power to restructure the group where the corporate structure is such that it prevents effective supervision, strengthened supervision of groups whose parent company is outside Europe to avoid incentivising groups to circumvent Solvency II requirements by establishing their head office outside Europe.

[72] This includes clarifications on the way to account for equivalent third-country insurers in the group solvency calculation (currently, a legal gap allows to not take account of currency risk), to account for small subsidiaries (proportionality), to integrate non-insurance financial institutions and on rules governing capital transferability within a group.

cooperation between the Home and Host supervisory authorities would be introduced, and EIOPA's coordination role would be strengthened.

Benefits

Option 2 would have a **positive effect on the quality of cross-border supervision and the convergence of supervisory practices of insurance groups** as it would remove existing gaps and uncertainties. Therefore, it would improve the level-playing field within the Union and increase legal certainty for insurance businesses. By ensuring a stronger focus on cross-border supervision and cooperation between national authorities, Option 2 would also **improve the ability of supervisors to protect policyholders and beneficiaries**. Option 2 also ensures stronger coordination by EIOPA which would be empowered to settle a disagreement between authorities on complex cross-border cases. This would ensure higher consistency of supervision and contribute to a more harmonised level of policyholder protection. For those reasons, Option 2 is expected to improve the functioning, and therefore the trust in the internal market.

In addition, Option 2 would **reduce the risk of regulatory arbitrage**, in particular the opportunities to circumvent European prudential rules. Indeed, group supervision would apply in a consistent manner regardless of the group structure, the type of parent company or the location of the head office. In particular, Option 2 would imply stricter rules governing the supervision of groups headquartered outside Europe, including better monitoring of third-country risk exposures for European entities, and more focus on capital and financial outflows from the European companies to the wider international part of the group. Such an approach would ensure that the European subgroup remains sufficiently capitalised and that policyholders are better protected. Therefore, Option 2 would reduce incentives for a European group to move its head office outside Europe, and would strengthen **the level-playing field between EU and non-EU insurance groups**. As regards cross-border supervision, enhanced information exchange would help national authorities protect policyholders against forum shopping[73] by those applicants who have been rejected elsewhere.

Option 2 would contribute to **improving risk sensitivity and policyholder protection**, as it would lead to a clearer and more robust regulatory framework in terms of how to assess the transferability of capital within an insurance group, including for entities from different financial sectors (e.g. banks) or countries (e.g. subsidiaries from third countries) should contribute to group risks.

Option 2 also **includes elements of proportionality**: for instance, insurance groups for which the consolidation of small and less complex insurance entities would generate undue compliance costs would be allowed to use simplified rules. Similarly, the strengthened information exchange requirements between supervisory authorities would be subject to proportionality considerations, with the aim to limit unnecessary administrative burdens and compliance costs. Therefore, Option 2 would contribute to proportionality, although some of the new rules may make the framework more complex (although clearer) than under current rules.

Option 2 would **contribute to preventing systemic risks** by ensuring that insurance groups take into account both financial and non-financial exposures to all types of companies within the group, including those belonging to other financial sectors and non-regulated companies. Therefore, any spillover effect stemming from the interaction

[73] Forum shopping makes reference to the practice of choosing for licensing authority which is likely to provide the most favourable outcome.

between insurance and non-insurance entities would be closely monitored. In addition, the enhanced risk sensitivity and the more efficient capital allocation within insurance groups would reduce the likelihood that insurers take excessive risk, and would therefore decrease the risk of build-up of systemic risk.

Finally, the further integration of the Single Market for insurance services stemming from this option can indirectly stimulate the cross-border supply of innovative insurance solutions, including those covering risks related to natural catastrophe, climate change. Therefore, Option 2 can have an indirect positive effect on insurers' **contribution to a more sustainable and resilient European economy**. By improving rules on group supervision Option 2 would also indirectly incentivise insurance groups to optimise their capital allocation and diversify their risks across the different entities of the group, which can also have positive impacts on the ability to provide funding in long term and sustainable assets across Europe.

Costs

Option 2 would have a **slightly negative effect on insurance groups' competitiveness at international level**, as it would generate overall a limited increase in quantitative requirements, as explained in EIOPA's impact assessment. In addition, although it is expected that this impact may be concentrated on a few active international groups with complex structures, material activities outside Europe, and possibly other financial activities (e.g. banking). For those groups, Option 2 would lead to a slight deterioration in their international competitiveness as the lower level of "free excess capital" or the higher capital requirements stemming from third-country subsidiaries could be seen as reducing their ability to expand internationally. On the other hand, as explained above, the strengthening of the supervision of third-country groups stemming from Option 3 would imply that non-EU groups do not have a competitive advantage over EU ones when establishing a European subsidiary.

In order to assess the significance of **implementation costs,** EIOPA invited 83 insurance groups from 20 EEA Member States to participate to a survey. 41% of respondents indicated that EIOPA's draft proposals would have significant one-off cost, and 36% that on-going costs would remain significant. Similarly, a survey submitted to NSAs suggests that implementation costs for supervisory authorities is expected to remain limited, as only 7% and 21% of respondents indicated expecting significant increase in one-off or ongoing costs depending on the amendment considered. As EIOPA amended its proposals and simplified technical changes, which were assessed as generating the most significant implementation costs, the actual implementation costs stemming from Option 2 is expected to be lower. As regards cross-border supervision, implementation costs are expected to be limited for the insurance industry. Option 2 would require more information exchange between NSAs, which may generate additional work in Member States where insurers have significant cross-border activities. The stronger focus on cross-border activities implies dedicating sufficient resources to it. However, in practice this cost is expected to be limited as Option 2 would imply upgrading into European law principles that are already part of the Decision on the collaboration between supervisory authorities, and are therefore expected to be already agreed and applied by supervisory authorities.

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would be more effective than the baseline on improving the quality of supervision. On cross-border supervision, Option 2 would be effective in removing any gap to cooperation and information exchange

between supervisory authorities, and ensure a level-playing field with the Union by ensuring that the principles set out in EIOPA's non-binding tools become EU law. Option 2 increases legal certainty for supervisors, insurance companies and groups, and is cost-effective by simply formalising into EU legislation what is supposed to be existing best practices. European coordination by EIOPA also ensures an efficient and consistent implementation of the rules across the Union. On group supervision, Option 2 would in contrast to the baseline be effective as the proposed changes would clarify and strengthen the legal framework and increase the quality and convergence of supervision. The measures taken by choosing Option 2 come with a cost, in particular to insurance groups but also to public authorities. In general a cost benefit analysis as such is not possible in the regulatory context as the expected benefits are not quantifiable. However, it is important that the desired outcome cannot be achieved in a less cost intensive way, as ultimately policyholders have to bear any increase in cost. Also any unjustified cost would harm the international competiveness of the Union's insurance sector. The measures under Option 2 consider the above elements and there is no more efficient way in achieving the desired outcome. Option 2 is also coherent with specific objectives of this review as well as with the primary objectives of Solvency II (policyholder protection and financial stability).

Winners and losers: The clarification of the framework and increased cooperation of public authorities would lead to a better and more consistent level of consumer protection across Europe. Insurance groups would face in general slightly stricter rules by clarifying the framework and applying it equally across the Union. In particular, those groups, which have interpreted deficiencies in the current framework in their favour, would face a considerable increase in the level of regulation. On the contrary, insurance groups are also winners as there are also elements in Option 2 they would be benefitting from. It is also the general interest to have a level-playing field for insurance groups, irrespective of whether the groups are headquartered inside or outside the EU. Similarly, more consistent and efficient supervision of cross-border business would improve supervisory convergence and level-playing field and would therefore deepen the integration of the Single Market for insurance services, with positive impact on insurance business. Finally, impact on supervisors is somehow mixed, as they would benefit from enhanced cooperation and coordination between them, and more legal certainty in the interpretation of prudential rules. On the other hand, their responsibilities and the resources needed for the supervision of cross-border business would have a cost, as well as the stricter requirements for information exchange and cooperation, under EIOPA's coordination.

Stakeholder views: In the context of EIOPA's consultation activities, insurance groups, notably internationally active ones, expressed strong concerns about EIOPA's proposals, in particular those which would result in an increase in capital requirements. This partly results from the possibility that due to the lack of clarity of the current framework insurance groups and NSAs have interpreted the framework in their own way[74], and any clarification of the rules may lead to an increase in capital requirements for some groups[75]. However, single voices acknowledge the need for harmonization and clearer rules, in particular regarding capital requirement calculations. Furthermore, internationally active groups, which are the most affected by the implementation of Option 2, perceived a risk of deterioration in their international competitiveness. This

[74] For instance, some NSAs may fully waive group supervision, whereas other authorities would not do so.
[75] For instance, insurance groups have different approaches when quantifying risks at group level stemming from non-regulated holding companies or from subsidiaries headquartered in so-called "equivalent third countries". For further explanations of the concrete technical issues, please refer to Section 4 of Annex 8.

concern has also been raised by a few public authorities as part of the Commission's public consultation.

As regards cross-border activities, as part of the Commission's public consultation, the majority of stakeholders (81%) who expressed a view on this topic are satisfied with the current approach according to which cross-border activities are supervised by national authorities under the coordination of EIOPA where appropriate. The insurance industry generally supports enhanced information exchange between authorities and a stronger mediation role by EIOPA. In addition, the majority of stakeholders who had a view on cross-border supervision (58%) supported reinforcing the role of the Host supervisor when the Home authority does not take appropriate measures to address identified deficiencies. This concerns in particular consumers/citizens/NGOs and insurers having a view on this issue (respectively 83% and 55% of support), as feedback were more split among public authorities, illustrating the complex debates around the most effective balance of powers and responsibilities between the different supervisory authorities. Finally, some of EIOPA's proposals are criticized by insurance stakeholders, notably the empowerment granted to Host supervisors to directly request information from insurers rather than asking access to them via the Home authority, which is not assessed as an improvement of the functioning of the Single Market.

6.4.2. Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner

Under Option 3, and in line with EIOPA's advice, rules aiming at the prevention of failures would be strengthened, and, a framework for the orderly resolution of insurers would be introduced with the objective to protect policyholders, beneficiaries and claimants, as well as to ensure the continuity of insurance functions whose disruption could harm financial stability and/or the real economy, and to protect public funds. This would notably encompass:

- the requirement for insurers to draft pre-emptive recovery plans describing the possible actions that would be taken in order to remedy a potential non-compliance with capital requirements;
- the establishment of national resolution authorities that would draft resolution plans and would assess and, where necessary, improve the resolvability of insurers. Resolution would be triggered when the insurer is no longer viable or likely to be no longer viable and when a resolution is necessary in the public interest, i.e. to achieve the resolution objectives above.

The resolution authority would be equipped with a range of resolution tools and powers that provide an administrative alternative to insolvency. For cross-border groups, the effective planning and coordination between national resolution authorities in case of an insurer's distress would be organised in resolution colleges of all relevant authorities involved in supervision and resolution under the control of the lead resolution authority.

The costs and benefits of those elements were thoroughly assessed and consulted upon at two occasions by EIOPA,[76]. The main insights are reflected in the following analysis.

[76] See sections 11.6 and 12 in EIOPA's Impact Assessment and section 12 in the Background Document. EIOPA's Opinion on the review of Solvency II was preceded by an Opinion on the harmonisation of recovery and resolution frameworks for (re)insurers across the Member States (5 July 2017) and a Discussion Paper on Resolution Funding and National Insurance Guarantee Schemes (EIOPA, July 2018).

Benefits

Option 3 would **further decrease the likelihood of insurance failures** and, in particular, provide a credible framework to address the distress of insurers whose failure could negatively affect policyholders. As such, it **improves the level of policyholder protection.**

A harmonised set of powers to prevent and address failures with consistent design, implementation and enforcement features would **foster cross-border cooperation and coordination** during crises and help to avoid any unnecessary economic costs stemming from uncoordinated decision-making processes between different public authorities and courts. Effective cross-border arrangements would also help ensure that the interests of all affected Member States, including those where the parent company is located as well as those where the subsidiaries and branches of a failing group are operating, are given due consideration and are balanced appropriately during the planning phase, and when recovery and resolution measures are taken. Hence, it would address potential risks of conflicts of interest for local supervisory and resolution authorities to give priority to the protection of "local" policyholders over other stakeholders. A harmonised approach would also **foster the level-playing field** and avoid regulatory arbitrage. Option 3 is largely in line with international standards for systemic risk in the insurance sector. As such, it **would not affect EU insurers' competitiveness**.

Option 3 would be **applied in a proportionate way**. Planning requirements would depend on a set of criteria, i.e. the size, cross-border activity, business model, risk profile, interconnectedness and substitutability of services of insurers. In addition, simplified obligations would be applied where the supervisory or resolution authority deems it possible. The existence of critical functions and other functions that are material for the financial system or the real economy should additionally be taken into account for the decision on the need for proportionate resolution planning. Therefore, the scope of resolution planning would be smaller than that of pre-emptive recovery planning.

Finally, Option 3 would also have a **positive impact on preventing systemic risks**. Indeed, the resolution framework would allow maintaining financial stability, and ensuring the continuity of functions by insurers whose disruption could harm financial stability and/or the real economy and to protect public funds (by limiting the risk of needing to "bail-out" failing insurers).[77]

Costs

The **implementation costs** related to Option 3 stem mostly from the planning and resolvability assessment requirements. Public authorities would have to bear the costs of establishing a resolution authority, supervising pre-emptive recovery plans, resolution planning and cross-border coordination work. EIOPA's impact assessment provides an overview of the range of costs estimated by the NSAs for drafting and maintaining resolution plans and resolvability assessments as well as for the supervision of pre-emptive recovery plans.[78]

[77] See ESRB, Recovery and resolution for the EU insurance sector: a macroprudential perspective, 2017.

[78] It should be stressed that the aim was gathering an initial and high-level overview of where the cost range could be. There was no detailed description of which items should be included per category in order to allow for the application of proportionality, which explains the amplitude of the range. Furthermore, in most cases such plans are not in place yet. When this was the case, NSAs were asked to provide an estimation based on their experience with other plans/reports.

	Drafting and maintaining of resolution plans		Drafting and maintaining of resolvability assessments	
	One-off costs	On-going costs	One-off costs	On-going costs
Staff (per year)	0.2 – 5 FTE	0.08 – 4 FTE	0.08 – 3 FTE	0.03 – 2 FTE
IT costs (internal)	€ 2,500 – 100,000	€ 250 – 29,000	€ 2,500 – 100,000	€ 250 – 29,000
IT costs (external)	€ 2,500 – 100,000	€ 3000 – 20,000	€ 10,000 – 100,000	€ 3,000 – 20,000
Fees to externals (e.g. consultants)	€ 6,000 – 100,000	€ 4,000 – 100,000	€ 2,000 – 100,000	€ 4,000 – 100,000
Other costs[79]		€ 2,400		

Similarly, the one-off costs estimated by NSAs for the supervision of pre-emptive recovery plans would lie between 0.04 and 5 FTE, and the on-going costs between 0.06 and 3 FTE.

Insurers would face costs from drafting pre-emptive recovery plans but also from resolution planning where they have to provide information to the resolution authority or make changes to address impediments to resolvability. No assessment of additional costs is available, but recovery plans would be integrated in the ongoing risk management of insurers and the cost of drafting ORSA reports and contingency planning could serve as a source of input for the drafting of the pre-emptive recovery plan. In view of the different approaches to the financing of resolution[80], it would not be appropriate to require in the EU framework – as is the case in banking – the financing of a resolution fund or the building-up of liabilities that could be bailed-in for the purpose of loss absorption and recapitalisation of failing insurers. These measures would result in inflating the balance sheet of insurers to create a loss absorbing capacity in proportion of their technical provisions that would entail higher costs for the industry and impose additional servicing risks on the companies that would not be justified by materially increased benefits[81].

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would effectively address the identified problem drivers of lack of preparedness, delayed intervention, inappropriate toolbox and uncoordinated management of cross-border (near-) failures combined with a home bias to address such issues. It would also provide an alternative to insolvency. While it is important to establish clear rules on powers to foster the recovery and enable the resolution of failing of insurers where this becomes necessary, in particular in cross-border situations, Option 3 would remain a minimum harmonisation approach, which takes into account proportionality elements. In particular, national insolvency procedures would remain a possible exit from the market for a failed insurer. Option 3 would also ensure that supervisory intervention remains judgement based and that the trigger of recovery measures remains the breach of capital requirements. Therefore, there would be no new additional intervention levels in Solvency II. However, it is necessary to introduce specific conditions for entry into resolution in order to address situations where an insurer would be systemic if it fails. This is in line with international guidance and standards. The policyholder protection and financial stability objectives would be coherent with the objectives of Solvency II and Option 3 would extend these objectives to the management of failures.

[79] They include cost of materials and catering/meeting costs for all recovery and resolution activities.

[80] See FSB, Developing Effective Resolution Strategies and Plans for Systemically Important Insurers, 2016.

[81] EIOPA considered and consulted upon these options in the Discussion Paper on Resolution Funding and National Insurance Guarantee Schemes (EIOPA 30July 2018).

The establishment of a recovery and resolution framework for insurers is also a necessary step to improve the options for recovery and resolution of financial conglomerates. So far, only the banking part of a conglomerate is subject to the Banking Recovery and Resolution Directive. An EU framework is also necessary to address any legal uncertainties about the interaction with other parts of EU legislation[82] that national solutions could face.

Winners and losers: Policyholders, the society at large and public authorities would benefit from a decreased likelihood of failure, better resolutions of crises and from financial stability. Member State authorities would have to bear the costs of establishing a resolution authority, resolution planning and cross-border coordination work. Insurers would face higher costs from recovery planning but also from resolution planning where they have to provide information to the resolution authority. On the other hand, pre-emptive planning enhances the awareness of and preparedness for adverse situations. This allows companies to take informed and timely remedial actions when needed. Many insurers would also benefit from a more level-playing field in the measures taken by authorities to restore their financial conditions or resolve them.

Stakeholder views: Feedback to the Commission's public consultation confirmed the results of EIOPA's consultation that there are generally divided views on this topic. On the one hand, the insurance industry consider that insurers and authorities are sufficiently prepared to deal with distressed insurers (51% yes, 19% no, 30 % no answer). On the other hand, public authorities, NGOs, consumer associations and citizens consider them insufficiently prepared (10% yes, 60% no, 30% no answer) and welcome further initiatives in this field. In particular, according to the insurance industry, there should be no intervention points for NSAs as long as capital requirements have not been breached, and run-offs and portfolio transfers are sufficient to deal with the large majority of failures. In their view, more intrusive tools should therefore be very cautiously considered. While the toolkit of resolution powers needs to be complete to address the failure of large and complex insurers, it is expected that traditional tools would be indeed the first choice of resolution authorities. Feedback to EIOPA's consultation further highlighted that while most stakeholders agreed that the application of the proportionality principle is essential, some oppose the proposal that the requirement to have pre-emptive recovery and resolution plans should capture a specific share of each national market. Finally, some respondents to EIOPA's consultation also expressed concerns on the applicability of the intended framework to reinsurers for two main arguments: (a) the fact that reinsurance is a business-to-business activity with limited policyholders' protection implications and (b) the nature and type of risks as well as its limited contribution to systemic risk.

6.4.3. Option 4: Introduce minimum harmonising rules to protect policyholders in the event of an insurer's failure

Under Option 4, which would be in line with EIOPA's general approach, a coherent EU framework for IGS would be implemented in all Member States by way of a dedicated EU Directive. It would ensure that all policyholders[83] acquiring insurance policies in the EU would benefit from a harmonised minimum level of protection in the event that an insurance company defaults. Based on minimum harmonisation, the EU framework would introduce an obligation to establish IGS and determine a coherent set of minimum

[82] For example, company law, financial collateral and settlement finality directives.

[83] In this section, the term "policyholders" refers to policyholders, beneficiaries and injured third parties which should all be eligible claimants.

requirements, but would provide flexibility to Member States to adapt IGS protection to the varying characteristics of local insurance markets.

Annex 5 examines in detail the different options for technical features of the design of a minimum harmonised EU framework for IGS, as well as the related costs and benefits. On this basis, assuming EU action, the preferred features would be the harmonisation of the geographic scope according to the home-country principle[84], as well as the coverage of a minimum scope of eligible policies, encompassing life and selected non-life insurance policies, to a harmonised minimum level by either paying compensation or ensuring continuity of insurance policies. Mechanisms for cross-border cooperation and coordination would also be established. In order to ensure an adequate protection of policyholders, an IGS would need to be adequately funded (see sub-section on costs below), taking into consideration the specificities of insurance activities and of local markets.

Benefits

Action taken at EU level would **benefit primarily policyholders by increasing their protection** in the event that insurers are unable to fulfil their commitments. This would also foster the trust in a **properly functioning Single Market for insurance** and increase consumer choice by ensuring that consumers feel comfortable in purchasing insurance provided by insurers from other Member States, including innovative solutions aimed at improving the resilience of our economies against systemic risks (natural catastrophes, cyber-risks, etc.). The introduction of IGSs in all Member States would additionally reduce the risk of recourse to public funds to protect policyholders from losses, and could shield public funds from a potential liability of around EUR 21 billion[85] on an aggregated based, based on estimations provided in Annex 5. The proposed policy options are expected to generate two main advantages for the economy. First, they would ensure a level-playing field that would address the existing competitive distortions between domestic and non-domestic insurers. By contributing to the safety and well-functioning of the internal market for insurance services, the envisaged EU action would facilitate the provision of cross-border activities for individual insurers and groups. Second, EU action would reduce the risk of allocating losses to policyholders and taxpayers in a sub-optimal fashion, thereby also contributing to improved overall social welfare. In addition, EU action based on the home-country principle would align and enhance supervisory incentives, including in the context of cross-border activities, as the financial consequences of a failure would have to be borne consistently by the insurers of the Home Member State.

Costs

Introducing IGSs throughout the EU would also have a **direct cost for insurers and an indirect cost for policyholders**, as insurers would pass on part of their contributions to consumers through increased premiums. IGS can be financed either ex-ante, or ex-post

[84] Where an IGS follows home-country principle, domestic policyholders would be protected by the national IGS only if the insurer from which they bought a policy is headquartered in the same Member State. In addition, policyholders buying a policy from a foreign insurer that operates on a cross-border basis, would be protected by the IGS of the Member State of the foreign insurer if this IGS also follows the home-country principle.

[85] This amount corresponds to the losses estimated at EU-level that an insurance failure could generate and that an EU framework of IGS should be able to cover based on a confidence interval of 99%, meaning that in one loss event out of 100, the resources provisioned by the Fund will not be sufficient to cover the incurred loss. This estimation varies according to the underlying parameters, such as the confidence interval and the assumed probability of default of insurers, and the IGS design features.

(following a failure case), or through a combination of both approaches. EIOPA suggested a combination of ex ante and ex post funding.[86] In an ex-post funded scheme, resources would remain with the contributing institutions until a failure occurs, and levies would be paid only once losses arise and are known. However, ex-post funding may entail payout delays and would be more exposed to moral hazard, as failed insurers would have never contributed to the IGS. Furthermore, depending on the market circumstances and the degree of market concentration, raising contributions following the failure of an insurer could have a pro-cyclical effect. In a pre-funded scheme, funding is readily available, pro-cyclicality is avoided, and the incentive structure is preserved, contributing to market discipline. Annex 5 discusses the pros and cons of the financing models in more details.

IGS funds can be considered as the additional premiums that policyholders pay to insure themselves against the insolvency of their insurer. The payments made by each policyholder can be considered roughly equivalent to the expected value of the losses they would avoid incurring, in the event that their insurers defaulted. Depending on the specificities of national insolvency frameworks, the possibility to use alternative funding mechanisms and the use of certain resolution tools, actual funding needs in Member States may be lower than those estimated by the model in Annex 5. In addition, the financial burden could be smoothened over a sufficiently long transition period in order to maintain the yearly impact at an acceptable level. While risk-based ex-ante contributions create the preferred incentive structure for all types of insurance commitments, the choice of a funding structure may also need to reflect that some insurance products have more limited payout and maturity profiles. These considerations may be suitable to balance adequately the interests of all stakeholders and should be assessed globally with other elements of the Solvency II review.

As shown in Annex 5, the building up of a protection scheme in all Member States could require around EUR 21 billion. This currently corresponds to 2.33% of annual gross written premiums. Applying this target level over, for instance, a 10-year horizon would translate into an annual contribution of 0.233% of gross written premiums or EUR 2.33 per yearly policy of EUR 1,000. However, this estimate does not take account of the funds that are already available in the current national IGS that are pre-funded.[87]

EU action on IGSs would also affect insurers in different ways, depending on whether they operate in Member States that already have an IGS or not and depending on the specific market structures in place. For insurers, unlike policyholders, these contributions – or at least the portion that would not be passed on to policyholders – constitute a financial cost in themselves (and not an early payment), as losses hitting insurers in the event of default only depend on capital, not on premiums paid. The financial costs for the industry can be computed by using the Solvency II cost of capital rate of 5%[88]. For an IGS with a level of funding of 2.33% of annual premiums, this would translate into financial (capital) costs of about 0.12% of annual premiums.

[86] EIOPA suggested that IGSs should be funded on the basis of ex-ante contributions by insurers, possibly complemented by ex-post funding arrangements in case of capital shortfalls and that further work is needed in relation to specific situations where a pure ex-post funding model could potentially work, subject to adequate safeguards.

[87] Not all necessary information could be collected to determine the full level of current pre-funding in the Member States.

[88] See Sub-section 6.2.2 of the impact assessment and Sub-section 3.2.2 of Annex 8.

Overall assessment

Effectiveness, efficiency and coherence: The minimum harmonisation of a network of IGS would address the problem drivers that lead to insufficient policyholder protection in case of failure by closing the identified gaps and by removing potential overlaps. In the event that insurers fail, IGSs would absorb insurers' losses up to at least the EU minimum coverage level. This mutualised "tail-risk" protection would achieve a high level of security for policyholders and beneficiaries in a cost-effective manner (i.e. considering the smoothing and mutualisation effect) by covering the potential excess losses that would not be accounted for by existing capital requirements (or any available excess capital). The pre-funded nature of the funding and its spreading among a larger base (of insurers and of end-consumers) would provide the desired level of protection at a lower cost and in a counter-cyclical manner. However, insurance failures remain rare events. Therefore, the potential costs and challenges (see the sub-section on "winners and losers" below) of EU minimum harmonisation have to be assessed bearing in mind the level of protection that is sought throughout the Single Market and the level of risk tolerance that policyholders and/or taxpayers may accept (as they have to ultimately bear the losses of insurance failures). In contrast to normal court-based insolvency proceedings, IGSs would help ensure a swift pay-out to policyholders, minimise potential social hardship and possibly bring to zero the loss incurred by policyholders at the time of failure, and, introduce an element of predictability and certainty on the effects of the failure of an insurance company for its policyholders. By optimising these elements together with a better allocation of insurance failure losses, an EU minimum harmonisation framework for IGS would contribute to maximising EU social welfare, developing a more competitive EU market and achieving consumers' trust in the internal market for insurance. The design of IGS features, in particular an *ex-ante* risk-based contribution mechanism, could address and manage potential moral hazard effects that could be linked to the introduction of a framework of protection schemes. On the supervisory side, minimum harmonisation in accordance with the home country principle would be coherent with the supervisory architecture of Solvency II as it would reinforce incentives for the adequate supervision of cross-border branches and direct sales of national insurers. It would also complement and follow the same approach as the proposed revision of the Motor Insurance Directive that ensures third party protection in the case of insurance failure for the specific product of motor third party liability.

Winners and losers: Overall, policyholders would benefit from EU action that would offer them an increased protection in the event that insurers fail irrespective of their place of residence and of where they bought their insurance cover. The associated costs could be seen as a premium for being insured against such failure. In exchange, policyholders and beneficiaries would have the certainty that their eligible claims would be covered, even in adverse circumstances. Similarly, the EU action on IGS would benefit taxpayers, as the likelihood that public resources would need to be used in the future in case of default of an insurance undertaking would be reduced. On the one hand, as explained above, where no pre-funded IGS has been established so far, or in the cases where the scope would need to be extended, insurance companies and policyholders would face additional financial costs. On the other hand, EU action would eliminate the existing duplication of levies that might currently be imposed on firms that perform cross-border activities. In addition, an IGS framework would contribute to reinforcing market discipline, level-playing field and competitiveness and ensure a better functioning of the internal market for insurance that would be beneficial for insurance companies as a whole. Finally, existing IGS schemes would be affected to the extent that the framework established at EU level deviates from the national IGS framework in place, in particular

where the minimum level of protection established at EU level would exceed their coverage.

Stakeholder views: During the Commission's public consultation, participants were asked whether IGSs should become mandatory across the EU. Overall, views were split among respondents. NGOs/consumers/citizens who expressed a view were largely in favour. The main rationale behind supporting the requirement to set up IGS was the enhancement of policyholders' protection and the strengthening of the Single Market. By contrast, public authorities and insurance industry representatives that responded to the consultation were mainly opposed. A strong focus on proportionate minimum harmonisation takes these concerns into account. However, a quarter of the industry respondents, notably five national insurance associations, supported IGS minimum harmonisation. In the Commission expert group, a majority of Member States was of the opinion that minimum harmonisation would be beneficial (see Annex 2). During EIOPA's consultation activities, several stakeholders agreed that there should be a minimum degree of harmonisation but that its legal structure should be left to national discretion. Other stakeholders, mostly from the industry, were against a harmonisation in the field of IGSs. Some respondents also pointed at a lack of harmonization of the supervisory practices (see Sub-section 6.1.3 of the Evaluation Annex) and of recovery and resolution frameworks.

6.4.4. Choice of preferred options

The below tables provides a high-level summary of how the previously described options compare and interact (note that for the sake of readability of the tables, the labels of the Options have been shortened). The incremental impacts of each of these options remain broadly similar whether they are compared to the baseline option or between them, as alternatives to foster policyholder protection.

In relation to Option 2, the assessment has to reflect possibly contradictory effects of changes on group supervision and cross-border supervision. For instance, regarding effectiveness on quality of supervision, there is a strong added value of changes in relation to group supervision due to the removal of legal gaps and uncertainties. In relation to cross-border supervision, while the effect of Option 2 is overall positive, the added value depends on the extent to which the principles embedded in existing soft convergence tools (notably the Decision on Collaboration) are already applied by national authorities (for those countries which already full apply those principles, the improved effectiveness would be limited).

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1 – *Do nothing*	0	0	0	0	0	0	**0**	**0**
Option 2 – *Improve quality of supervision*	+	+	0	0	++	+	++	++
Option 3 – *Introduce rules to avert / manage failing insurers*	0	0	0	+	++	++	++	++
Option 4 – *Introduce rules to protect policyholders when insurers fail*	+	0	0	0	+++	+	++	++

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	+/-	++	+/-
Option 3	+/-	++	+
Option 4	-	+++	**0**

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect **0** = no effect - = Slightly negative -- = Negative --- = very negative

Remedying legal uncertainties and strengthening the way supervisors apply Solvency II and cooperate, in particular in a cross-border context is a prerequisite to improving quality of supervision and policyholder protection. Similarly, reinforcing the coordination and mediation role of EIOPA would be coherent with the maximum harmonisation approach of Solvency II in relation to supervision. Therefore, Option 2 would be effective in improving the quality of ongoing supervision of insurance companies and groups and improve the level-playing field and the integration of the Single Market for insurance services. However, considered alone, it would not contribute fully to the objectives of an EU action in terms of addressing adequately the management of an insurer's failure and ensuring policyholders' protection in such a case.

In order to foster further supervisory convergence and support policyholder protection, Option 3 would further clarify and strengthen the Solvency II provisions that aim at addressing the deterioration of the financial situation of insurers. However, as the possibility of an insurance failure can never be entirely excluded, Option 3 would also implement a resolution framework that would ensure the continuity of an insurer's important functions for the economy, minimise reliance on public financial support and mitigate the adverse effects on financial stability in comparison to normal insolvency proceedings. Therefore, these additional benefits of Option 3 in terms of reducing negative social and welfare effects of an insurer's failure would justify the additional costs of recovery and resolution planning as long as they are applied in a proportionate manner.

At the same time, normal insolvency proceedings would remain a possibility under Option 3. In this case, as illustrated by recent insurance failures, it cannot be excluded that losses have to be borne by policyholders. In addition, even in the context of a resolution framework, the successful implementation of some tools, such as a transfer of portfolio, may require to haircut the value of some policies. Options 2 and 3 alone would thus not ensure that policyholders are shielded completely from social or financial hardship resulting from their insurer's failure. Depending on the judgement on the need to mitigate these risks for individual policyholders in all Member States, Option 4 could implement an effective IGS protection that would safeguard the confidence of consumers in the Single Market for insurance and ensure a level-playing field across the EU. By its design, Option 4 would contribute to fostering market discipline and to incentivise insurers to adequately monitor and manage their risks. It would also contribute to the effectiveness of Option 2 by reinforcing the incentives for supervisors to exert appropriate oversight on cross-border business. However, Option 4 would entail additional implementation costs the amount of which would depend on the design and on the starting point of the different Member States, as explained in above and in Annex 5. In conclusion, all three options are complementary and contribute together to the achievement of the objectives set for EU action.

The preferred options to address Problem 4 are Option 2 (Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision)[89] and Option 3 (Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner). Option 4 (Introduce minimum harmonising rules to protect policyholders in the event of an insurer's failure) presents costs and benefits according to the desired level of protection for policyholders across the EU in case of failures of insurers that need to be considered in the broader context of the current focus on economic recovery.

6.5. Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

6.5.1. Option 2: Make targeted amendments to prevent financial stability risks

Under Option 2, targeted amendments to the framework would be introduced to prevent the building-up of systemic risks stemming from or amplified by the insurance and reinsurance sector, which could be detrimental to financial stability. Those tools would in particular aim at:

- Better incorporating macro-prudential considerations in insurers' investment and risk management activities: insurance companies would be required to take into account how the macroeconomic developments can affect their underwriting and investment activities, and reciprocally how their activities may affect market drivers;
- Preventing liquidity risks: insurance companies would be required to strengthen liquidity management planning and reporting, while supervisors would be able to intervene whenever any resulting liquidity vulnerabilities are not appropriately addressed by insurers. In addition, as a last resort measure, supervisory authorities would have the power to temporarily freeze redemption options on life insurance policies to avoid "insurance run";
- Avoiding excessive risk-taking: prudential rules would be amended so that banking-type loan origination activities by insurers are not subject to a more preferential treatment than in the banking sector thus preventing regulatory arbitrage and curtailing "shadow-banking";
- Preserving capital position of vulnerable insurers during exceptional situations: in crisis situations, supervisory authorities would be granted the power to restrict or suspend dividend distributions and variable remunerations on a case-by-case basis, in order to preserve an appropriate capital position for the insurance sector.

Where necessary, EIOPA would be mandated to develop technical standards or guidance regarding operational details of these tools.

Benefits

Option 2 would determine a **very tangible improvement of the ability of supervisors to monitor and prevent systemic risks stemming** from or affecting the insurance sector. In addition, this option would further reduce pro-cyclical behaviours by insurers[90] and would ultimately produce positive effects for the stability of financial markets in the longer term. Insurers would be required to incorporate macro-prudential considerations in their underwriting and investment activities, which would limit excessive risk-taking

[89] Please refer to Sections 4 and 5 of Annex 8 for further details on amendments to the rules governing group supervision and cross-border supervision.
[90] Those pro-cyclical behaviours may destabilise market pricing.

behaviours. Supervisors would be entitled to intervene in case of liquidity vulnerabilities that are not addressed or to ensure prudent capital management during crisis situations, in the interest of policyholders and to preserve financial stability. Option 2 would also be **in line with a risk-based framework**, because supervisory intervention on dividends policies would be entitled only when justified by the application of risk-based considerations and criteria. As there is no quantitative requirement for liquidity risk as in the banking sector, those additional tools would ensure that liquidity risk is appropriately monitored and controlled without imposing standardised liquidity metric which would not be fit for the specificities of different insurers' business models.

In addition, while not affecting volatility and not directly improving risk sensitivity, Option 2 would still require that insurers better take into account sector-wide developments and liquidity risks in a prospective manner, and therefore would provide good incentives for improved risk management beyond capital requirements.

Costs

Option 2 could possibly **depress, to a certain extent, insurers' ability to invest in activities which may provide long-term and sustainable financing to the economy**. However, this would only occur when prudentially justified (for instance the inclusion of a macro-prudential dimension in investment activities could discard some specific investments which may generate financial stability risks although they could still allow for better expected returns for policyholders), and with the aim of ensuring the long-term stability of financial markets and the broader economy. In addition, additional focus on liquidity risks may prompt insurers to divest from certain "illiquid" assets if these contribute to systemic risks, although such investments could be considered beneficial for the purpose of achieving the CMU objectives (e.g. investments in unlisted equity of SMEs).

Option 2 would **increase the complexity** of the framework because it would introduce new risk management requirements for insurers. Still, Option 2 would also aim at ensuring that the new requirements are **implemented in a proportionate manner**. For instance, EIOPA proposes that supervisory authorities should have the power to waive requirements in relation to liquidity risk management planning depending on the nature, scale, and complexity of the insurer's activities.

Although Option 2 would grant supervisors with a common set of macro-prudential tools to prevent systemic risks, it cannot be excluded that supervisors facing similar systemic risks emerging at national level would not act in the same way. Even with guidance and coordination at EU level, supervisors would still be in a position to deviate from supervisory recommendations put forward by EIOPA or the European Systemic Risk Board (ESRB). Such an issue already materialised in the context of the statements by EIOPA and the ESRB in 2020 to prohibit dividend distributions by European insurers, where some NSAs decided to deviate from EIOPA's approach (i.e. insurers in some countries could distribute dividends whereas their direct competitors in others could not).

A **lack of harmonisation in supervisory responses** to financial stability concerns may hinder public authorities' ability to address sector-wide systemic risks at European level, considering that macro-prudential policy would largely remain a national competence. However, Option 2 would still be an improvement compared to the baseline as public authorities would still be granted new powers to prevent financial stability risks at least at national level. Option 2 would also **negatively affect the level-playing field** if some insurers were imposed additional requirements (e.g. dividend restrictions) whereas their competitors were not while facing similar risks. Similarly, in relation to waivers of some

requirements (e.g. liquidity requirements), EIOPA proposes to issue guidelines, but those non-binding tools would not necessarily ensure consistency across Member States.

The new tools would be in line with the international framework for systemic risk[91], and would not result in an increase in capital requirements. However, the power for supervisors to restrict or suspend dividend distributions could increase financing costs for European insurers compared to non-European ones. Therefore, Option 2 would have a slightly potential **negative impact on insurers' international competitiveness**. On the other hand, such restrictions could improve or preserve the solvency ratio of insurers during exceptional situations (such as adverse economic or market events), and thus contribute to policyholder protection and the preservation of financial stability.

Finally, Option 2 would **imply moderate implementation costs** for the insurance industry. Indeed, based on a survey included in EIOPA's impact assessment, 61% of insurers do not currently include a macro-prudential perspective in their investment and risk management activities, and among them, 59% (i.e. 36% of all insurers surveyed) identify that such a requirement would generate significant additional costs (although such costs are not quantified). Similarly, almost half of insurers (48%) do not yet produce a liquidity risk management plan. However, EIOPA estimates that drafting and maintaining such a plan involves very limited additional human and financial resources as shown in the below table:

	Staff costs	Other costs (including IT and fees to externals)
Average one-off costs	0.46 full-time equivalent (FTE) = 0.06% of total employees	€ 30,546 = 0.0008% of liabilities towards policyholders
Average ongoing annual costs	0.41 full-time equivalent (FTE) = 0.05% of total employees	€ 14,233 = 0.0004% of liabilities towards policyholders.

The additional cost of reviewing such plans would also be limited for supervisory authorities. EIOPA considers that the average one-off cost for public authorities would lie between 0.05 and 3 FTE, and the average ongoing cost between 0.03 and 2 FTE.

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would be effective in preventing systemic risks without overburdening the current system. It would therefore be coherent with one of the main objectives of Solvency II, namely financial stability. In addition, Option 2 would be consistent with the international standards; regulatory capital requirements would remain based on the risks faced by individual insurers and excessive risk-taking would be prevented without introducing limitations to insurers' ability to invest for the long-term, nor through additional "cost of capital". Still, supervisors would have new tools to address excessive risk taking and liquidity risks, and to ensure that macro-prudential concerns are appropriately embedded in insurers' activities. Implementation costs for such new tools would be moderate. Efficiency would be achieved as more "far-reaching and stronger" tools (liquidity and capital buffers, concentration limits), while contributing to financial stability, may generate additional costs (including opportunity costs in terms of contribution to the long-term and

[91] The possibilities to impose capital surcharges for systemic risk and/or to set soft concentration thresholds on investments are only mentioned in the "Guidance" part of the IAIS Insurance Core Principles (see ICP 10.2.6). According to the IAIS, "Guidance facilitates the understanding and application of the Principle Statement and/or standards; it does not represent any requirements".

sustainable financing of the economy and international competitiveness) and uncertain benefits. In fact, the added value and the appropriateness of those "far-reaching" tools have not been demonstrated and remain at this stage hypothetical. Finally, regulatory arbitrage between banks and insurers regarding banking-type activities would be prevented and the role of supervisors would be enhanced in the context of liquidity risks, although no discretionary powers to impose "liquidity buffers" would be introduced. EIOPA and ESRB would continue to be central in exercising systemic risks' oversight and facilitating dialogue and coordination among NSAs, although national authorities would still have the final word.

Winners and losers: Improved financial stability would have no direct effect on policyholder protection. However, financial instability risks and possible spill-over effects on the real economy could affect policyholders both as taxpayers (since business failures and economic recession may require public intervention) and as workers (since EIOPA demonstrates that there is a correlation between financial instability and unemployment). On the contrary, some of the tools embedded in Option 2 (in particular, the power to freeze the exercise of surrender options on life insurance contracts) may be considered detrimental to policyholders in the short term. However, this would only be a last resort measure to avoid the failure of an insurer, which may result in financial losses for all remaining policyholders in the longer run.

The impact of Option 2 is mixed. Shareholders of insurers might be considered losers in the short term because of the possibility of dividend restrictions, however as such restrictions would strengthen the solvency position of insurers and thus their probability of survival, shareholders might win in the long run. Similarly, insurers conducting banking-type loan origination activities may face a slight increase in capital requirements due to more convergence with banking rules but this might benefit the economy in the long term as the risk of regulatory arbitrage is reduced. Insurers might also be considered winners as the possibility to freeze redemption rights would make them less exposed to liquidity risk under stressed circumstances. Other changes embedded in Option 2 would not make it more costly for them to conduct their underwriting and insurance activities. There would still be some implementations costs in relation to the development of enhanced risk management and reporting systems, which would include the macro-prudential dimension. However, as explained above, a number of insurers already embed such requirements in their processes (and thus those would face no implementation costs), and the implementation costs for those which do not apply them yet would remain moderate. Option 2 would also have a limited negative impact on insurers' capacity to compete at international level with non-European insurers. Supervisors would be winners compared to the status quo, although they may not be largely satisfied by Option 2 because they would not get a fully-fledged set of new powers as proposed by EIOPA and the ESRB and may consider they lack certain tools to address potential systemic risks. At the same time, Option 2 would not limit the wide margin of discretion that they have in the exercise of macro-prudential supervision.

Stakeholder views: The feedback to EIOPA's and the Commission's consultations are not fully consistent. In the context of EIOPA's consultations, the vast majority of stakeholders expressed the view that should amendments be brought to Solvency II in order to incorporate a macro-prudential dimension, such changes should remain limited, broadly in line with Option 2. The situation is however more nuanced for respondents to the Commission's public consultation, where only 27% of respondents (42% if we exclude those who did not provide an answer to the question) expressed support for targeted amendments only (the alternatives being either no change or a broad range of new powers). However, among public authorities, 63% (71% if we exclude those with no

answer) express support for targeted amendments. A specific question of the Commission's consultation was about circumstances in which public authorities should have the power to freeze surrender rights. The majority of respondents expressed support for such a power, either at the level of individual insurers when they are in weak financial position or in financial distress (41%) or at sectoral level (24%). This applies to all stakeholder categories.

6.5.2. Option 3: Introduce an extensive macro-prudential framework

Under Option 3, a broad range of macro-prudential tools would be included in Solvency II, which are partly inspired from the banking sector although adapted to the insurance context. In addition to those tools already mentioned in Option 2, Option 3 would grant additional powers to supervisors with the aim of further avoiding excessive risk-taking activities and liquidity risk.

In relation to risk-taking, Option 3 would encompass, in addition to the tools already covered by Option 2, the following discretionary powers for NSAs, subject to possible EIOPA's technical standards and guidance where deemed appropriate:

- imposing capital surcharges for systemic risk to single insurers that are deemed "too big to fail" or to insurers whose common (herding) risky behaviour may pose issues to financial stability, and/or countercyclical buffers in order to increase own fund requirements when market credit spread levels are lower than their historical average and may indicate the presence of a system-wide underestimation of risks (i.e. to ensure that insurers establish a buffer against future increases in spreads);
- imposing (soft) concentration limits on investments so that supervisors can decide to intervene when insurers' investments are deemed excessively concentrated in certain asset classes or sectors and public authorities consider that systemic risks may be generated or amplified by these asset classes or sectors;
- requiring the establishment and maintenance of a systemic risk management plan (SRMP) so that insurers that are deemed to be systemic or to undertake systematically risky activities have to plan and report to supervisors all applicable measures that they intend to undertake in order to address their systematically risky activities;
- prohibiting at sector-wide level dividend distributions and variable remuneration under crisis situations, regardless of the individual solvency position of insurers.

In relation to liquidity, under Option 3, supervisors would impose, in addition to the tools of Option 2, discretionary liquidity buffers to insurers that they deem to have a "vulnerable" liquidity profile (for instance, high exposure to derivatives, which may generate risks of massive margin calls if financial markets deteriorate). Those buffers would be calculated based on standardized liquidity metrics inspired from the banking sector, but adapted to the insurance context.

Benefits

Option 3 would have a **very positive effect on the ability of supervisors to preserve financial stability** and address systemic risks stemming from or affecting the insurance sector. This option would also contribute to stabilise financial markets in the long term by avoiding excessive concentrations or excessively risky behaviours of insurers. Supervisors would indeed be granted with a large set of tools aiming at (i) limiting insurers' risk taking activities which may generate "price bubbles", (ii) ensuring that insurers are not exposed to material liquidity risks, including in relation to margin calls on derivative transactions and possible massive exercise of surrender options by

policyholders and (iii) preserving the financial solvency of the sector by limiting insurers' ability to make payments to shareholders under crisis situations. Capital surcharges may mitigate both entity based[92], activity-based[93] and behaviour-based sources of systemic risk. Concentration thresholds would be "soft" thresholds, in the meaning that the intensity of the supervisory response to a breach of threshold would be fully discretionary (and may consist in simply engaging dialogue between the supervisor and the firm). Liquidity buffers would be based on standardized liquidity metrics and would ensure that liquidity risk is assessed in a consistent way across Europe, although the decision to impose such buffers would remain discretionary.

In addition, Option 3 would, to a certain extent, **improve risk sensitivity** by taking into account the state of financial markets (in particular credit spreads) in capital requirements. In addition, it would ensure that the risk related to loan origination activities is not underestimated compared to the banking sector (by making risk factors of the Solvency II counterparty default risk more consistent with those of the banking credit risk framework). This would be an improvement to policyholder protection.

Finally, Option 3 would be **in line with international agreed standards**, which require supervisors to act appropriately to reduce systemic risk when identified, assess the potential systemic importance of insurers and target supervisory requirements to those insurers.

Costs

Option 3 would **affect insurers' ability to contribute to the long-term sustainable financing of the economy**. Option 3 would indeed imply that certain insurers, if systemic risks are identified, may be incentivised or required to hold more liquid (due to the liquidity buffers) and less risky assets (i.e. cash and money-market funds, due to capital surcharges or concentration limits) to the detriment of asset classes such as equity, bonds and securitisations. While macro-prudential tools would be subject to supervisory discretion, the uncertainty surrounding their use by public authorities may indeed incentivise insurers to anticipate such restrictions and implicitly embed them in their investment behaviour and capital management, in particular if public authorities indicate that they identify systemic risks in these asset classes. Option 3 would also **reduce insurers' profitability,** as the capital surcharges and concentration limits, where applied, may increase capital costs or reduce investment opportunities. In turn, their activation would have a **negative impact on EU insurers' international competitiveness**, as these specific tools are not part of the macro-prudential framework in other jurisdictions. The risk of being restricted in investment decisions or in dividend distributions would put European insurers at a disadvantage vis-a-vis their international competitors, albeit at the benefit of being better prepared to cope with systemic risks. The uncertainty for investors regarding the actual level of capital requirements (including buffers) on insurers and decisions on dividend restrictions may increase the relative financing cost for EU insurers compared to third-country companies. In addition, lower risk taking would also limit insurers' ability to supply (life) insurance policies that meet consumers' demand.

[92] i.e. preventing the failure of an insurer that is "too-big-to-fail" at national level. Note that in the context of the "holistic framework for systemic risks" developed at international level, no insurer has been identified as globally systematically important at this stage. However, the IAIS Holistic framework requires supervisors to have 'an established process to assess the potential systemic importance of individual insurers and the insurance sector.'

[93] i.e. reducing contagion risks stemming from non-insurance activities conducted by insurers (e.g. banking-type activities which may be systemic).

Although EIOPA's Opinion highlights that macro-prudential tools should be implemented in a proportionate manner, no concrete safeguard is proposed to ensure that this principle is satisfied. As shown in Section 6.2 of the Evaluation Annex, a general and abstract principle of proportionality does not result in an effective implementation within Solvency II. Therefore, Option 3 would not guarantee that its effective implementation would ensure coherence with the overarching principle of proportionality embedded in Solvency II. Ensuring proportionality would require further conditions or technical standards that have not been developed by EIOPA as part of its Opinion on the Solvency II review. In any case, **Option 3 would imply that the framework would become more complex and less predictable** for firms, notably in terms of capital management policies.

In addition, most of the tools that would be introduced as part of this option would be largely discretionary in nature (e.g. capital surcharges would be defined subject to supervisory judgement, the level of concentration thresholds and supervisory response to a breach of thresholds would be discretionary, as well as the definition of liquidity buffers or restrictions on dividend payments). Although EIOPA's Opinion acknowledges that further guidance or technical standards would be needed at a later stage (through non-binding guideline by EIOPA for instance), Option 3 could lead to **further inconsistencies between national supervisory processes**, as also explained in Option 2. If the very same situation does not trigger a similar supervisory response (e.g. no application of capital surcharge for systemic risk in one jurisdiction but imposition of such buffers in others), there would be a risk of unequal **level-playing field** within the European Union, as some jurisdictions may be less willing to address systemic risks than others.

Finally, Option 3 would **imply moderate implementation costs** for the insurance industry. In addition to those identified in Option 2, the main additional implementation cost would be in relation to systemic risk management plans. EIOPA estimates that the drafting and maintenance of both liquidity management and systemic risk management plans involves limited additional human and financial resources as shown in the below table.

	Staff costs	Other costs (including IT and fees to externals)
Average one-off costs	0.96 full-time equivalent (FTE) = 0.13% of total employees	€ 70,879 = 0.0022% of liabilities towards policyholders
Average ongoing annual costs	0.81 full-time equivalent (FTE) = 0.11% of total employees	€ 49,923 = 0.0014% of liabilities towards policyholders.

The additional cost of reviewing such plans would also be limited for supervisory authorities. EIOPA considers that the average one-off cost for public authorities would lie between 0.1 and 6 FTE, and the average ongoing cost between 0.08 and 4 FTE.

Overall assessment

Effectiveness, efficiency and coherence: By granting all the necessary tools that may be needed to address macro-prudential concerns, Option 3 would be the most effective option to preserve financial stability. However, if Option 3 was chosen, the EU would go further than other jurisdictions in addressing potential sources of systemic risks (for instance widespread collective reactions of firms to exogenous market shocks). Some of the sources of systemic risks in the insurance sector remain quite theoretical until now as

they have not materialised yet. Furthermore, the articulation between risk-based capital requirements and capital surcharges defined at individual level to prevent excessive risk taking is not straightforward. In particular, as discussed as part of the first problem on long-term and sustainable financing of the economy, it is acknowledged that capital requirements – although not being the main driver of investment decisions – may generate undue disincentives to invest in certain asset classes, in particular equity. Introducing the power for supervisors to impose systemic capital surcharge or concentration thresholds on equity investments would contradict such diagnosis. It could also undermine any solution aiming to address the insufficient incentives for long-term equity financing in situations where further investments in equity would not affect policyholder protection[94]. Furthermore, the risk-based nature of capital requirements makes it less justified to add capital buffers or to impose ex-ante concentration thresholds at individual level. Capital requirements in Solvency II are conceived in a way that insurers are actually discouraged to take excessive risk on assets which generate high capital charges (or otherwise they would have to be so highly capitalised to be in a position to weather market downturns and stick to their investments when the economic cycle is at a low level).

The main exception would be government bonds because they are not subject to any capital charge under standard formula rules (therefore, quantitative rules do not deter concentration in such investments). However, the "prudent person principle" embedded in Solvency II ensures that the risk of concentration in any asset class or in certain counterparties is duly monitored and mitigated by insurers. An expansion of such principle to integrate "macro-prudential" considerations (as envisaged in both Option 2 and Option 3) would similarly enhance supervisors' possibility to discourage excessive concentrations or excessive expositions to temporary "price bubbles". Similarly, countercyclical buffers, which could be imposed when spreads are low (as proposed by the ESRB), would be to a certain extent redundant because the risk of rising spreads is already captured in existing capital charges for spread risks. This was the reason why this tool was not retained in EIOPA's final Opinion.

In addition, as described above, the additional tools which are conceived as part of Option 3 would make it more difficult for insurers to compete at international level and more costly for them to invest in "real" assets (which may be more risky and less liquid). Option 3 would be coherent with the objectives of Solvency II (financial stability) although it may enter in conflict with other political objectives (e.g. facilitating insurers' contribution to the Capital Markets Union). In addition, the power for supervisors to impose a sector-wide blanket ban on dividend distributions without the application of risk-based criteria related to the risk appetite limits/tolerance, which are firm-specific, would undermine the credibility of capital requirements. In fact, under this approach, even an insurer which is very well capitalised (e.g. with a solvency ratio above 300%) could be subject to such restrictions if a sector-wide blanket ban was imposed.

Winners and losers: Like in Option 2, policyholders would be in a relatively neutral position, as improved financial stability would have no short-term direct effect on policyholder protection (while only indirect effect on taxpayers and workers in the longer term). However, if financial stability was threatened, insurance firms, as well as policyholders, would be affected. On the contrary, some of the tools embedded in Option 3 (e.g. power for NSAs to freeze the exercise of redemption options on life insurance

[94] Note that the Solvency II asset class for long-term investment in equities relies on criteria some of which aim at ensuring that insurers can stick to their investments and are not exposed to forced selling at deteriorated market prices under stressed situations.

contracts) may, like in Option 2, be harmful to some policyholders in the short term. Insurers would be losers under Option 3 as it would be more costly for them to conduct their activities, and to generate return on investments, in particular because potential capital surcharges for systemic risks and concentration limits on investments may constrain their ability to "search for yield" and their capital management. On the other hand, Option 3 might be beneficial for their longer-term survival, as well as for preventing such kinds of behaviour for financial stability purposes. Option 3 would also make it more difficult to compete at international level with non-European insurers that are not subject to similar rules. Shareholders would thus lose as they could receive less dividends. On the other hand, shareholders would lose if insurance companies were to fail more easily during exceptional situations (e.g. during a financial crisis). Finally, supervisors would be largely winners of this option, due to the enhanced and fully-fledged set of new powers at their disposal and the wide margin of discretion that they would have when using them in practice.

Stakeholder views: The vast majority of respondents to EIOPA's consultations opposed the introduction a fully-fledged macro-prudential framework in Solvency II. This is more or less in line with the Commission's public consultation where only 22% of respondents who expressed a view supported a broad set of new tools in Solvency II. Support ranges from 13% (public authorities) to 30% (NGOs/consumers/citizens) depending on the stakeholder category. Therefore, Option 3 would receive limited support by stakeholders. As regards the power to freeze surrender rights, please refer to the summary provided as part of the analysis of Option 2.

6.5.3. Choice of the preferred option

The below tables provides a high-level summary of how the previously described options compare (note that for the sake of readability of the tables, the labels of the Options have been shortened).

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1 – *Do nothing*	0	0	0	0	0	0	**0**	--
Option 2 – *Make targeted amendments to prevent financial stability risks*	-	+	0	+/-	--	++	+	++
Option 3 – *Introduce an extensive macro-prudential framework*	---	+	+	-	---	+++	---	--

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	+/-	+	+/-
Option 3	---	++	+++

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

Option 3 would be the most effective in preserving financial stability. However, it could generate significant additional costs for capital management for the insurance industry.

There is no evidence that those costs outweigh the added value of the new powers that would be granted to supervisors. In addition, the material risk of inconsistent approach in their application may also be detrimental to the level-playing field. In comparison, Option 2 seems to find the right balance between the need to enrich the supervisory toolkit to address systemic risks, in line with international standards, while ensuring a proportionate increase in complexity and limited additional costs for the capital management of the insurance industry.

The preferred option to address Problem 5 is Option 2 (Make targeted amendments to prevent financial stability risks)[95].

7. PREFERRED COMBINATION OF OPTIONS

As discussed in Section 6, the selection of certain options to achieve an objective has been done with the aim of maximizing the effectiveness in addressing the specific objective related to a problem while limiting the costs and potential negative side effects on other specific objectives.

The following tables summarize the impact of the different preferred options.

[95] Please refer to Section 6 of Annex 8 for further details on the macro-prudential framework stemming from the preferred option.

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Baseline: Do nothing (in all areas)	0	0	0
Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy			
Option 2: Facilitate long-term investments in equity	++	+/-	+
Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	-	+++	+
Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies			
Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes	+	++	-
Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers			
Option 3: Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.	++	-	-
Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures			
Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision	+/-	++	+/-
Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner.	+/-	++	+
Option 4: Introduce minimum harmonising rules to protect policyholder in the event of an insurer's failure	-	+++	0
Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector			
Option 2: make targeted amendments to prevent financial stability risks in the insurance sector	+/-	+	+/-

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volatility	Proportionality	Supervision - protection against failures	Financial stability		
Baseline: Do nothing (in all areas)	0	0	0	0	0	0	0	--
Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy								
Option 2: Facilitate long-term investments in equity	++	-	-	0	+	-	++	++
Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	+	0	0	0	+	++	+	++
Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies								
Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes	+++	++	+++	-	-	++	++	++
Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers								
Option 3: Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.	0	0	0	+++	-	-	++	+
Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures								
Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision	+	+	0	0	++	+	++	++
Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner.	0	0	0	+	++	++	++	++
Option 4: Introduce minimum harmonising rules to protect policyholder in the event of an insurer's failure	+	0	0	0	+++	+	++	++
Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector								
Option 2: make targeted amendments to prevent financial stability risks in the insurance sector	-	+	0	+/-	--	++	++	++

7.1. General impacts[96]

Most options retained have a positive effect in supporting **insurers' long term and sustainable financing of the European economy**. By facilitating the use of the long-term equity asset class which benefits from a preferential treatment, by requiring that insurers incorporate climate and sustainability considerations in their investment and underwriting activities, and by reducing the volatility of the framework, insurers benefit from a conducive prudential environment, which fosters long-termism and sustainability in investment decisions. Other options retained, which reduce regulatory compliance costs and facilitate the dissemination of insurance supply that can improve resilience against climate change and/or natural catastrophes, also have a positive impact. The proposal to make targeted changes to Solvency II in relation to financial stability may hinder the objective of long-term financing and greening of the economy. It achieves however the appropriate trade-off between what is needed in order to ensure that public authorities have the appropriate toolkit to address systemic risks, and the limitation of side effects on the political objectives of the Capital Markets Union and the European Green Deal. In addition, the framing of the revised criteria for long-term investments in equity would aim at rewards where insurers are able to avoid forced selling under stressed situations, which limits the risk that the insurance sector could amplify systemic financial market turmoil.

Furthermore, the combination of preferred options **reduces volatility, but also improves risk sensitivity** by appropriately reflecting the risk of negative interest rates in capital requirements and in the valuation of insurers' liabilities towards policyholders. The clarification of prudential rules in relation to group supervision, and the targeted amendment on macro-prudential supervision in relation to banking-type activities by insurers (to remove risks of regulatory arbitrage) also contribute to improving risk sensitivity. However, the revision of the eligibility criteria for long-term equity investments, which aims at facilitating its use by insurers, would reduce the risk-sensitivity of the framework as EIOPA's analysis concludes that the preferential treatment on such investments is not justified by evidence. Still, EIOPA did not recommend removing this asset class, and on the contrary supported the objective of clarifying supervisory criteria for its use. There is a clear trade-off between risk sensitivity and facilitation of long-term equity, but the deterioration of risk sensitivity generated by the facilitation of the use of the long-term equity asset class seem limited (as the classification criteria remain robust) and are justified by the political priority given to the completion of the Capital Markets Union. Still, overall, the level of prudence of the framework is slightly increased compared to current rules.

One key consideration is the **overall balance of the review in terms of capital requirements.** Based on EIOPA's impact assessment, the Commission services tried to quantify the impact of all changes brought on the average solvency position of insurers at two different reference dates. The below table provides a summary of those calculations – assuming that no transitional period would be introduced. It shows that the impact of the review depends on how low interest rates are. The review would in all cases improve the capital surplus at EEA level, although there would be a slight decrease in solvency ratios. The impact would in any case be spread over several years and would result in the short term in an increase in capital resources in excess of capital requirements of up to €

[96] Please also refer to Annex 3 for further details.

90 billion euros which would facilitate insurers' contribution to the post-Covid recovery. At the end of this phasing-in period, the overall impact would depend on market conditions, but would in any case imply an increase in insurers' capital resources in excess of capital requirements as shown in the below table. The below figures which show the long-term impact of the review are provided for the sample of insurers which participated to EIOPA's data collection exercises, as well as for the whole EU market. As the figures for the whole market are "extrapolated" from the sample, they may be less reliable. Note that those figures provide a floor to the impact of the review, as they do not take into account the extinction of older contracts with high guaranteed rates which generate more capital requirements[97].

	Reference date end of 2019		Reference date mid-2020	
	Change in solvency ratio compared to under current rules	Change in excess own funds compared to current rules	Change in solvency ratio compared to under current rules	Change in excess own funds over compared to current rules
Combined effect on quantitative rules of all recommendations by EIOPA	-13 percentage points *(from 247% to 233%)*	- EUR 15 billion (sample) - EUR 18 billion (whole market)	-22 percentage points *(from 226% to 204%)*	- EUR 40 billion (sample) - EUR 55 billion (whole market)
Combined effect on quantitative rules of all preferred options	-2 percentage points *(from 247% to 245%)*	**+ EUR 16 billion (sample)** **+EUR 30 billion (whole market)**	-3 percentage points *(from 226% to 223%)*	**+ EUR 8 billion (sample)** **+16 EUR billion (whole market)**

In addition, as the negative changes would be gradually implemented over at least five years, any cost of the review would be smoothened, and insurers would be given sufficient time to issue new capital or debt instruments if needed. Finally, as the average solvency ratio by mid-2020 remained above 220%, the few percentage points change in solvency ratios, spread over five years, would not have had a disruptive effect on the market. Therefore, the options chosen achieve a balanced – and even positive – outcome in terms of capital requirements. This also confirms the choice of not introducing those new macro-prudential tools, which would have an effect on capital requirements, as it would undermine the objective of "balance" while not being necessarily technically justified. The technical changes retained in order to address volatility have a slightly negative impact on the simplicity of the framework, but those changes remain moderate.

The combination of options is improving **proportionality** by excluding more insurers from Solvency II and by applying automatic proportionality to a number of insurers, which have a low-risk profile. As the outcome of the review, up to 20% of insurers would be excluded from Solvency II, to be compared with 14% under current rules. This represents a significant increase while ensuring that the vast majority of insurers remain subject to Solvency II. The technical changes retained in order to address volatility have a negative but limited impact on the simplicity of the framework. Therefore, overall, the review would achieve its objective of making the framework simpler for less complex insurers.

[97] More precisely, the negative impact of changes on interest rates is more significant for contracts with higher interest rates. As such contracts with higher interest rates are usually older, their extinction over time is expected to result in a lower long-term impact of changes on interest rates. Therefore, at the end of the phasing-in period, the overall impact of the review is expected to be even more positive than what the table suggests, as this table does not reflect the extinction of the older contracts.

The quality and consistency of supervision and policyholder protection would be improved by clarifying rules on group supervision, by remedying gaps in and insufficient coordination on cross-border supervision, and by considering the introduction of minimum harmonising rules on recovery, resolution and IGSs. Based on Commission services' calculations (see Annex 5), the financial (capital) costs of introducing IGSs for the industry is estimated to be about 0.12% of annual premiums. In absolute terms, these estimated costs[98] are justified by the benefits of introducing IGSs for policyholders, taxpayers and the economy more broadly. Clearer rules in those fields also contribute to improving the level-playing field within the EU, by ensuring that rules are applied consistently across the EU. The clarification of criteria for long-term equity investments would also contribute to this objective. However, the enhancement of proportionality, by excluding more firms from Solvency II, does not support "consistent supervision", as it reinforces the co-existence of a European regime with national frameworks. This is also the reason why it was preferred to prioritise proportionality for firms within Solvency II rather than to exclude a larger number of companies from the framework. In addition, the reduction of compliance costs for those firms outweighs the side effects on consistency of supervision. Should a small insurer want to operate cross-border, it would have to apply Solvency II. Therefore, the level-playing field within the Single Market would be preserved and even improved.

Finally, the combination of preferred options **contribute to preserving financial stability**, by granting supervisors targeted additional powers to address macro-prudential risks, including liquidity risk, but also by harmonising recovery and resolution frameworks that ensures the orderly management of insurers' failures, which could be facilitated by IGS funding. As explained above there are trade-offs to be found between achieving this objective and supporting insurers' long-term investments in equity (which implies facilitating risk taking). However, robust criteria for long-term equities (notably the clarification of expectations on how insurers can demonstrate their ability to hold on to their investments under stressed conditions) would avoid excessive risk taking. Similarly, there may also be trade-offs between proportionality and financial stability. Indeed, by excluding more firms from the mandatory scope of Solvency II, the combination of options reduces EIOPA's ability to have a European-wide consolidated view of macro-trends and the build-up of systemic risks. However, the firms concerned by exclusions represent less than a few percentage points in terms of both, gross written premiums and liabilities towards policyholders. Therefore, again, the benefit of enhancing proportionality outweighs the (limited) side effect on financial stability.

Finally, the cumulative impact of the options achieves a satisfactory balance for all types of stakeholders. **Insurers** benefit from better recognition of their long-term business model, by facilitating long-term investments and reducing the impact of short-term volatility, and by enhancing proportionality (hence reducing compliance costs). **Policyholders** are overall better off by the improved risk sensitivity, and the better integration of climate risks by insurers, but also by a higher quality of supervision and new layers of protection provided by the frameworks on recovery, resolution and on insurance guarantee schemes. **Supervisors** are relatively neutral with the review. In some areas, they benefit from clearer rules (e.g. on equity), on others, the framework becomes more complex to supervise (e.g. on volatility). Supervisors also lose some discretion in relation to proportionality, but gain new powers to preserve financial stability.

In conclusion, insurers would be subject to a prudential framework that is more conducive to long-term equity investments and better incorporates the long-term climate

[98] As explained in section 6.4.3, these estimated funding costs could actually be lower in the practice.

and sustainability risks. As such, insurers would have stronger incentives to play their pivotal role in the long-term capital funding and the greening of the European economy, and to support the economic recovery in the aftermath of the Covid-19 crisis, in line with the political objectives of the CMU and the European Green Deal. While making the framework more sensitive and contributing to the main objective of Solvency II (policyholder protection), the review would not have a market-disruptive impact on insurers' solvency ratios and would therefore not materially affect insurers' international competitiveness. While remaining very sophisticated, the framework would be designed in such a way that undue complexity is avoided for low-risk insurers, which would benefit from more proportionate and simpler rules. The initiative would also strengthen the trust in the Single Market for insurance services, by ensuring that Solvency II is applied in a more harmonised and more coordinated manner, in particular in relation to cross-border business. In addition, a more integrated Single Market would also be fostered by introducing new layers of policyholder protection against the consequences of insurers' (near-)failures through minimum harmonisation on resolution and IGSs. Finally, existing gaps in the toolbox for macro-prudential supervision would be addressed in a proportionate manner, by introducing new provisions, which would have a clear added value to prevent financial instability in line with international standards on systemic risks. While those tools could have a short-term implementation cost for insurers, they would benefit in the longer term from more robust risk management and a lower likelihood of financial instability.

7.2. Impact on SMEs

The review would have a positive impact on SMEs. First, the preferred options on proportionality would reduce compliance and regulatory costs by both excluding a larger number of small insurers from the scope of mandatory application of Solvency II, and enhancing the application of proportionate rules for other smaller and less complex insurers in the scope of Solvency II (see subsection 7.3 below). Second, all SMEs (beyond the insurance sector) would benefit from easier access to long term capital funding. Indeed, one of the preferred options implies simplifying the eligibility criteria for long-term equity investments, which is expected to facilitate the use of this asset class by insurers. Eligible equities would benefit from a risk factor of 22% instead of an average risk factor of 39% for listed equity and 49% for unlisted equity. Long-term investments in SMEs, which are largely unlisted, would therefore benefit from a higher capital relief than long-term investments in listed equities. Therefore, insurers would have an incentive to further provide long-term capital funding to SMEs[99].

7.3. REFIT (simplification and improved efficiency)

The review would only contribute to REFIT cost savings by addressing the problem insufficient proportionality of the current prudential rules.

[99] Note that according to current rules, eligibility criteria are already more flexible for investments in funds, such as European long-term investment funds pursuant to Regulation (EU) 2015/760, qualifying venture capital funds and qualifying social entrepreneurship funds as referred to in Article 3(b) of Regulations (EU) No 345/2013 and 346/2013 respectively. Indeed, for such funds, the satisfaction of the eligibility criteria is assessed at the level of the fund instead of the underlying assets. The relaxation of the eligibility criteria for long-term equities would also benefit such funds.

REFIT Cost Savings – Preferred Option(s)		
Description	***Amount (in €)***	***Comments***
Extension of the exclusion thresholds from the mandatory scope of Solvency II	Saving of up to EUR 500 million in ongoing compliance costs for insurers, which could be excluded if the policy option is implemented.	According to the "Study on the costs of compliance for the financial sector" the average "general" cost of compliance with Solvency II is € 12 million for one-off costs, and € 2.7 million for ongoing costs, which represent 3.18% and 0.96% respectively of total operating costs. Up to 186 firms would be excluded from the mandatory application of Solvency II due to the increased thresholds. This benefit would be partly offset by the implementation costs of applying national prudential frameworks, but those costs cannot be quantified. Additionally, some firms that are close to the thresholds may reach them in the coming years (however, we do not have the corresponding figure).
Identification of low-risk insurers, which would benefit from automatic application of proportionate rules	Saving of at least EUR 50 million in ongoing compliance costs for insurers	We make the conservative assumption that the requirements that can be subject to proportionality represent between 5% and 10% of total ongoing compliance costs. At least 249 firms would be identified as of low-risk profile. EIOPA's impact assessment does not contain quantitative data. Based on partial data from the industry, we could estimate that some elements of this policy option (reduced frequency of the reporting of the ORSA and of the mandatory review of internal written policies, possibility for the same person to cumulate "key functions" within a firm) could allow saving approximately up to 1 FTE[100]. The actual figure depends on the size of the company and the proportionality measures it is applying currently.

8. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED?

An evaluation of this initiative will be carried out five years after its entry into application.

Objectives	Indicator	Source of information	Data already collected?	Actor(s) responsible for data collection
Provide incentives for insurers' long-term sustainable financing of the economy.	% of equity in investment portfolios	Public EIOPA statistics	Yes	EIOPA
	Share of insurers' investments in SMEs	Quantitative reporting templates (QRTs)	No	EIOPA
	% of sustainable assets in investment portfolios	NFRD disclosures or QRTs	No	Commission EIOPA
Improve risk-sensitivity and mitigate short-term volatility in insurers' solvency position	Degree of asset-liability mismatch (duration gap)	QRTs	No	EIOPA
	Average level of guaranteed interest rate; difference between that average and long-term market interest rates	QRTs and EIOPA's risk-free curves	Partly	EIOPA
Increase proportionality of Solvency II to remove unnecessary administrative	Number and share of companies that are excluded from Solvency II	EIOPA register	Yes	EIOPA
	Number (and percentage) of companies that are classified as low-risk profile, as well as their market share; Number of proportionality measures applied	EIOPA's report on proportionality	No	EIOPA

[100] Source: AMICE.

burden and compliance costs	by them.			
	Number and market share of firms, which are granted proportionality measures although they do not meet all the criteria for low-risk profile	EIOPA's report on proportionality	No	EIOPA
Enhance quality, consistency and coordination of insurance supervision across the EU, and improve the protection of policyholders and beneficiaries, including when their insurer fails	Number of deficiencies in quality of supervision identified by EIOPA	EIOPA's peer review reports	Yes	EIOPA
	Number of questions received by EIOPA which require a legal interpretation and of those relating to the practical application or implementation of Solvency II provisions on group supervision[101]	EIOPA website	Yes	EIOPA
	Number of international insurance groups whose parent company is located in the EU	EIOPA register, QRTs, market data	Partly	EIOPA/NSAs
	Share of European insurance groups' premiums which are written outside the home jurisdiction, and outside the EEA	EIOPA register, QRTs, market data	Partly	EIOPA/NSAs
	Share of insurers' premiums that are written outside the home jurisdiction, per line of business	QRTs, and other national sources	Yes	EIOPA/NSAs
	Number of cross-border cases solved following EIOPA's recommendations	EIOPA report	No	EIOPA
	Number of recovery plans drafted; number of resolution plans drafted	Information from NSAs	No	EIOPA/NSAs
	Number of winding up procedures	Official Journal	Yes	Commission
Better address the potential build-up of systemic risk in the insurance sector	Number of liquidity risk management plans drafted	Information from NSAs	No	EIOPA/NSAs
	Number of freezes of redemption options approved by NSAs	Information from NSAs	No	EIOPA/NSAs
	Number of firms subject to restrictions on dividend distributions for financial stability reasons	Information from NSAs	No	EIOPA/NSAs

[101] In the meaning of Article 16b(5) and 16b(1) respectively of Regulation (EU) 1094/2010.

ANNEX 1: PROCEDURAL INFORMATION

1. LEAD DG, DECIDE PLANNING/CWP REFERENCES

This Impact Assessment Report was prepared by Directorate D "Bank, Insurance and Financial Crime" of the Directorate General "Directorate-General for Financial Stability, Financial Services and Capital Markets Union" (DG FISMA).

The Decide Planning reference of the "Review of measures on taking up and pursuit of the insurance and reinsurance business (Solvency II)" is PLAN/2019/5384.

This initiative is part of the Commission's 2021 Work Programme[102]. Furthermore, parts of the initiative represent actions proposed by the European Commission to implement the European Green Deal[103] and the new Capital Markets Union action plan[104].

2. ORGANISATION AND TIMING

Several services of the Commission with an interest in the initiative have been involved in the development of this analysis.

Three Inter-Service Steering Group (ISSG) meetings, consisting of representatives from various Directorates-General of the Commission, were held in 2020 and 2021.

The first meeting took place on 6 March 2020, attended by DG CLIMA, COMP, LS and the Secretariat General (SG).

The second meeting was held on 21 January 2021. Representatives from DG CLIMA, COMP, ECFIN, GROW, LS and SG were present.

The third meeting was held on 1 March 2021 and was attended by DG CLIMA, COMP, ECFIN, ENER, GROW, MOVE and SG. This was the last meeting of the ISSG before the submission to the Regulatory Scrutiny Board on 19 March 2021. The meetings were chaired by SG.

DG FISMA has considered the comments made by DGs in the final version of the impact assessment. In particular, it has clarified the links of this initiative with other initiatives of the Commission as well as improved the coherence of this impact assessment with the impact assessments for those other initiatives. FISMA also added information as regards the specific impact on SMEs. The analysis of impacts and the preferred option takes account of the views and input of different DGs.

3. CONSULTATION OF THE RSB

The Impact Assessment report was examined by the Regulatory Scrutiny Board on 21 April 2021. The Board gave a positive opinion on 23 April 2021 following which the Commission made a few changes in order to address the Board's request to further develop the problem analysis and narrative in a consistent way. in the final version of the Impact Assessment.

[102] Commission Work Programme 2021: A Union of vitality in a world of fragility, COM(2020)690 final, 19 October 2020

[103] Communication from the Commission on the European Green Deal, COM(2019)640 final, 11 December 2019

[104] Communication from the Commission on a Capital Markets Union for people and businesses-new action plan, COM(2020)590 final, 24 September 2020

4. EVIDENCE, SOURCES AND QUALITY

The impact assessment draws on an extensive amount of desk research, meetings with stakeholders, a public conference, an open public consultations, an external study and opinions by EIOPA. The material used has been gathered since the Commission Services started monitoring the implementation of the Solvency II in 2016. This material includes but is not limited to the following:

- A public conference: "2020 Solvency II review: Challenges and opportunities", 29 January 2020, Brussels;
- Technical reports from EIOPA (see box below);
- Seven (29/03/19, 30/09/19, 19/02/20, 26/05/20, 10/11/20, 16/12/20, 01/02/21) (physical and virtual) meetings with Member State representatives in the Expert Group on Banking, Payments, Insurance and Resolution to gather the views on the revision of the Solvency II Directive;
- An Open online public consultation described in Annex 2, section 7;
- External study by Deloitte Belgium and CEPS for the Commission: Study on the drivers of investments in equity by insurers and pension funds, December 2019;
- The JRC Technical Report on Insurance Guarantee Schemes.

Overview of EIOPA's reports used for the purpose of this impact assessment.

Reports from EIOPA on certain aspects of the framework

Article 77f of the Solvency II Directive mandates EIOPA to report on an annual basis (from 2016 to 1 January 2021) to the European Parliament, the Council and the Commission about the impact of the applications of the so-called "long-term guarantee measures"[105] and the measures on equity risk[106].

EIOPA published such reports at the end of 2016, 2017, 2018, 2019 and 2020. They provide statistical data per national market on the availability of long-term guarantees in insurance products in each national market and the behaviour of insurers as long-term investors, on the use of the "long-term guarantee measures" and of measures on equity risk (number of firms applying each measure, the impact of each measure on the solvency position of insurers). They also provide information on the effect of the use of those measures on investment behaviours (including whether those measures provide undue capital relief), on competition, on product offering, and on "phasing-in plans" which should be adopted when an insurer does not comply with its capital requirements without transitional measures.

Similarly, in order to feed into the Commission's report on group supervision that were to be submitted to the European Parliament and the European Council in accordance with Article 242 of the Solvency II Directive, EIOPA submitted two reports on the functioning of group supervision, supervisory cooperation and capital management within insurance groups, in December 2017 and December 2018. Those reports listed a number of issues (legal gaps and inconsistencies in supervisory practices) which could hinder the effectiveness of group supervision. The 2018 report also identified several

[105] Long-term guarantee measures are the measures that aim at mitigating volatility of the framework. They include the volatility adjustment and the transitional measures applicable to the valuation of technical provisions.

[106] In particular, the symmetric adjustment on equity risk aiming to modulate the capital charge on equity investments depending on the state of the financial markets, so that capital requirements increase when stock markets are overheating and decrease when markets are plummeting

challenges in relation to cross-border supervision.

In addition, at the request of the Commission, EIOPA published in December 2019 a report on insurers' asset and liability management in relation to the illiquidity of their liabilities. This report provides information on insurance liabilities features (duration, redemption options, etc.), asset management of insurers (and its interaction with liabilities), the use of long-term guarantee measures and the market valuation of insurance liabilities.

Finally, EIOPA published an Opinion on the harmonisation of recovery and resolution frameworks for (re)insurers across the Member States in July 2017 and a discussion paper on resolution funding and national insurance guarantee schemes, developing potential principles for harmonisation, in July 2018. In this context, EIOPA also conducted a survey on the existing regimes in the Member States.

Those information were used as input to the evaluation and the impact assessment.

EIOPA's technical opinion on the review of the Solvency II Directive

On February 2019, the European Commission sent a request for technical advice to EIOPA covering eighteen areas of the framework. The advice was requested for June 2020. However, in view of the Covid-19 crisis, the deadline for this advice was extended to December 2020.

To support its work, EIOPA conducted two public consultations from mid-July to mid-October 2019 on reporting and public disclosure and on insurance guarantee schemes and a broader consultation on the other topics of the review from mid-October 2019 to January 2020. EIOPA also published a general feedback statement on the outcome of the consultation, as well as detailed resolution of stakeholders' comments (including on insurance guarantee schemes).

In addition, in order to quantify the impact of its proposals, EIOPA launched to requests for data collection to insurance companies from March to June 2020 and from July to September 2020.

EIOPA's advice on the 2020 review of Solvency II was eventually submitted on 17 December 2020, comprising a main document, as well as annexes of more detailed background analysis and comprehensive impact assessment at two different reference dates aiming to capture the impact of the proposed changes under normal times (end of 2019) and under crisis situations (mid-2020).

EIOPA's assessment is that the Solvency II framework is working well but that it needs to remain fit for purpose. In EIOPA's view, Solvency II needs to better reflect the low interest rate environment and to recognise that insurers with long-term and illiquid liabilities are particularly able to hold investments long-term. EIOPA's overall approach to the review has been therefore one of evolution not revolution aiming to address three areas where improvements are deemed needed:

- *Balanced update of the regulatory framework*: EIOPA proposes changes in several areas but which it considers balanced in terms of overall impact on insurers;
- *Recognition of the economic situation*, in particular, the persistence of low interest rates. EIOPA recommends revising the risk of interest rate changes;
- *Regulatory toolbox completion*, including better protection of policyholders via macro-prudential tools, recovery and resolution measures and insurance

guarantee schemes.

The material used to inform this impact assessment comes from reputable and well-recognised sources that act as benchmarks and reference points for the topic. Findings were cross-checked with results in different publications in order to avoid biases caused by outliers in the data or vested interests by authors.

ANNEX 2: STAKEHOLDER CONSULTATION

1. INTRODUCTION

As part of the Solvency II review, the European Commission will make legislative proposals expected in the third quarter of 2021. The review is an opportunity to reflect the current economic outlook, incorporate the political priorities of the European Union (the European Green Deal and the Capital Markets Union) and finally to build on the lessons learnt from the Covid-19 outbreak. Annex 2 aims to provide a summary of the ongoing consultation activities that will be considered when the Commission will be making its legislative proposal.

2. CONSULTATION STRATEGY

The consultation activities has fed into the European Commission's review process of the Solvency II framework. In order to collect the views of all stakeholders, the European Commission has built its consultation strategy on the following components:

- A conference on the 2020 Solvency II Review: challenges and opportunities bringing together the insurance industry, insurance associations, public authorities, civil society;
- An Inception Impact Assessment for the review;
- A public consultation open to all stakeholder groups;
- Targeted consultations of Member States.

3. CONFERENCE ON SOLVENCY II

The European Commission organized a conference, which took place on 29 January 2020, with three keynote speeches and four panel debates focusing on the key challenges for the insurance sector and the opportunities arising from the Solvency II review. Amongst keynote speakers and panellists: representatives from the insurance industry, insurance associations, national and EU authorities, civil society, and Members of the European Parliament.

The panels concluded that:

- The current economic and financial conditions are not adequately reflected in the prudential rules. There is a need to maintain a robust framework, while duly considering the CMU priorities. There are different views on which areas to review, but it is important to safeguard policyholder protection and to ensure that the prudential framework does not influence insurance product design.
- There is a need to clarify the scope and the rules for the application of the proportionality principle, improve legal certainty as well as achieve supervisory convergence.
- It is essential to ensure supervisory convergence and coordination, proved by several insurer failures operating cross-border. Panellists made several recommendations aiming to achieve proper functioning of the internal market and policyholder protection, while avoiding unnecessary costs for EU insurers.
- The insurance sector is exposed to emerging risks associated with climate change and new technologies. The new Climate Adaptation strategy aims to increase insurance penetration for climate risks. In addition, new technological innovation

creates challenges as well as opportunities for growth and enhanced competitiveness in the global market.

In the concluding remarks, the Commission services invited stakeholders to provide their views through the Public Consultation, which would complement EIOPA's technical advice and would be duly considered in the Commission's legislative proposal.

4. INCEPTION IMPACT ASSESSMENT

The Inception Impact Assessment aims to provide a detailed analysis on the actions to be taken at the EU level and the potential impact of different policy options on the economy, the society and the environment. In this context, the Commission ran an extended feedback period from 1 July to 26 August 2020, which was initially planned for four weeks. The Commission received twelve feedback responses across different stakeholder groups: insurance industry (six), public authorities (three), civil society (two), and academia (1).

4.1. Priorities of the Solvency II Review

Respondents acknowledged the need for a review but agreed on the fact that Solvency II has worked well to date, especially in the light of Brexit and the Covid-19 crisis. However, a few respondents focused on the need to find the balance between (i) financial stability and prudence and (ii) efficiency and growth. All respondents supported the objectives of the Solvency II review: ensuring policyholder protection, preserving financial stability and promoting fair and stable markets. A respondent highlighted the need to keep policyholder and beneficiaries protection as a top priority. In addition, some respondents also pointed out the consideration of international competitiveness in the Solvency II review and the need to keep a "risk-based" framework. Finally, the respondent from the academia underlined the necessity to reflect international financial accounting and IAIS developments in the review, as well as considering technology-related and ethical risks.

4.2. Long termism and sustainability

All respondents underlined the need to preserve the insurance industry's ability to contribute to the long-term financing and investment and the continuation of long-term product offering. Some respondents from the public authorities, insurance industry and academia supported that the ability to provide long-term guarantees should be a priority in order to serve consumers and set for the growth of the internal market. Moreover, the insurance industry called for a reduction to overall capital requirements to facilitate the insurance industry's contribution to the political objectives of the EU. In contrast, a public authority suggested that it is controversial to introduce political objectives in a prudential framework. All respondents agreed that the prudential framework should incentivize sustainable investment, while the insurance industry clarified that the incentives should be limited to the extent that Economic, Social and Governance (ESG) factors affect the insurer's risk profile.

4.3. Volatility and proportionality

The insurance industry underlined the necessity to better mitigate undue volatility to provide the right incentives (for long-term guarantee products and financing) and limit fire sales of assets, especially in the context of the low interest rate environment.

Respondents called for a better application of the proportionality principle. The insurance industry supported the extension of the proportionality principle thresholds to avoid

unnecessary cost and barriers. Mainly public authorities and the civil society, as well as some representatives from the insurance industry called for a consistent application of the proportionality principle to ensure the level-playing field. A respondent from the academia was against extending thresholds, since it is contradicting the harmonization objective at EU level.

4.4. Recovery, resolution, IGS, group supervision and cross-border supervision

Some respondents (mainly public authorities, civil society and academia) highlighted the need for improving harmonization of IGS to contribute to financial stability and ensure level-playing field. The insurance industry mainly supported that IGS and recovery and resolution should remain unchanged. A public authority pointed out that insurance recovery, resolution and IGS potentially lead to unnecessary high compliance costs.

In regards to cross-border supervision, all stakeholder categories pointed out towards a better coordination and information exchange between Home and Host supervisors. Some representatives from the insurance industry called for amendments to prudential rules in order to prevent regulatory and supervisory arbitrage.

Finally, one stakeholder recommended that the Solvency II Review should put more emphasize on group supervisions issues, and to reflect international developments in relation to systemic risks in the insurance sector ("Holistic framework" by the International Association of Insurance Supervisors).

5. PUBLIC CONSULTATION

The Commission launched a public consultation to obtain stakeholder views on the review of the Solvency II Directive. The feedback period ran from 1 July 2020 to 21 October 2020. The consultation received 73 responses from a variety of stakeholders representing the insurance industry (56%), civil society (14%) and public authorities (11%). Most respondents were stakeholders from the European Economic Area. The Commission services published a "summary report" on the feedback to this consultation on 1 February 2021[107]. A summary for the four topics of the public consultation results on the Solvency II Review is provided below. Please note that those who did not provide a view were not considered in the analysis of answers.

5.1. Long-termism and sustainability of insurers' activities and priorities of the European framework

5.1.1. Priorities of Solvency II and of the review

Respondents overall supported the three main objectives of the Solvency II: policyholder protection (top priority), financial stability, and fair and stable markets. Regarding the priorities of the Solvency II review, stakeholders were split. The most important priorities for the civil society and the public authorities were solvency, policyholder protection, and prevention of systemic risk. The insurance industry considered as very important the facilitation of long-term guarantee products and long-term and sustainable investments.

[107] Available at the following link: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12461-Review-of-measures-on-taking-up-and-pursuit-of-the-insurance-and-reinsurance-business-Solvency-II-/public-consultation

5.1.2. Long termism and sustainability

The majority of respondents who provided a view (87%) supported that the current treatment for equity and debt investments is not appropriate and stressed the necessity for re-assessing the risk margin, the criteria for long term equity and calibration of equity. Furthermore, most public authorities supported that framework gives the right incentives to provide long-term debt financing, while the insurance industry largely disagreed. Regarding the incentives for increasing sustainable investment and financing of SMEs under current rules, the insurance industry (78%) called for a better treatment, while the public authorities opposed it. In terms of preferential treatment for "green" investments, all stakeholder groups were mainly against it (60%). Finally, both public authorities and the insurance industry (78%) largely opposed the introduction of a brown-penalizing factor, while the civil society mainly supported it (80%).

5.1.3. Volatility, procyclicality and lessons learnt from the Covid-19 crisis

The insurance industry called for a review of the volatility adjustment and risk margin, and largely considered that the framework does not appropriately mitigate volatility (88%) and generates procyclical behaviours (65%). Public authorities were divided on the matter, while 70% of the civil society did not have a view.

In the context of the Covid-19 crisis, only a few participants identified new issues in relation to prudential rules, mainly public authorities. The answers received underlined the need to address short-term excessive volatility and also expressed that Solvency II does not provide enough possibilities for creating short-term crisis operational reliefs. Finally, some respondents suggested that the crisis revealed underestimation of interest rate risk and of correlation between underwriting and market risks.

5.1.4. Risk shifting to policyholders and impact of Solvency II

All stakeholder groups that expressed a view mentioned that Solvency II provides incentives for risk shifting to policyholders. In fact, stakeholders representing the civil society that had a view (75%) supported disincentivising life insurance guaranteed products in order to preserve financial stability. In contrast, the insurance industry and the public authorities opposed it and stressed the importance for product design freedom and sound risk management.

5.2. Proportionality of the European framework and transparency towards the public

5.2.1. Proportionality

Participants indicated that Solvency II imposes operational burden, complexity and cost to small insurers, with the majority of insurers who provided a view (70%) supporting the extension of the thresholds of exclusion from Solvency II. Public authorities and the civil society had mixed views on the matter, claiming that extending the scope of proportionality could potentially undermine policyholder protection and would negatively affect the level-playing field. Public authorities (67%) and the civil society (80%) mainly supported a potential preferential treatment of mutual insurers, while the insurance industry had mixed views. Finally, public authorities (71%) were the only stakeholder group opposing less discretion in applying proportionality by supervisory authorities.

The insurance industry (77%) was against imposing requirements for internal models users to calculate their solvency capital requirements under the standard formula, explaining that such a requirement would be burdensome and could create doubts on the credibility of internal models. The civil society was in favour claiming that it would enhance comparability and the level-playing field. Public authorities were either supporting the requirement but only for supervisory reporting or not supporting it at all.

5.2.2. Supervisory reporting and public disclosure

The insurance industry supported the inclusion of more automatic criteria for granting exemptions and limitations in supervisory reporting. In fact, some suggested to follow a risk-based approach with some supervisory discretion, rather than a size-based approach. The civil society was split of the matter, with the majority supporting automatic criteria with no discretion. The public authorities were split as to whether or not the status quo should be preserved. Some stakeholders pointed out the need to achieve consistent policyholder protection across EU, by introducing clear-cut criteria. Regarding the solvency and financial condition report (SFCR), participants pointed out the need to consider the audience, since it can be very complex, detailed and technical, especially for policyholders. Some respondents also suggested to reduce the length of the report as well as increase visibility of SFCR in insurers' website.

5.3. Improving trust and deepening the Single Market in insurance services

5.3.1. Cross-border supervision

The civil society (83%) supported enhanced safeguard powers of intervention by host authorities when needed, while the insurance industry and public authorities were divided on the matter. Some suggestions for additional powers include restrictive measures on product offering subject to some conditions, enhanced coordination between Host authorities, Home authorities and EIOPA and establishment of a specific "early warning alert system" for entities established in one member state but mainly operating in others. Finally, most participants (81%) supported cross-border supervision by national authorities with EU coordination where appropriate.

5.3.2. Recovery, resolution, and Insurance Guarantee Schemes

The insurance industry had confidence in insurers' and public authorities' preparedness in case of an adverse event (72%), while public authorities and the civil society (73%) had doubts on the matter. Some participants pointed out the need to have a harmonised recovery and resolution framework and proportionate application of the rules. In total, views on the need for EU action on IGS were rather split among respondents with 39% supporting it and 43% seeing no reason for it. Public authorities and the insurance industry were mainly against (62%) a mandatory setup of IGS, having concerns for the differences across countries that would affect the design and funding of IGS. However, a quarter of the industry respondents, notably several national insurance associations, supported action on IGSs. The civil society was largely in favour (75%), supporting that IGS would enhance policyholder protection and would strengthen the Single Market. Respondents agreed that the main role of IGS should be consistent policyholder protection across the EU and considered that compensation and continuation depends on the type of claim and policy. Finally, civil society was mainly supportive of a harmonized minimum level of protection by IGS (87.5%), while the two other stakeholder groups mainly opposed it (69%).

5.3.3. Macro-prudential tools in Solvency II

Public authorities and the civil society were mainly in favour for providing authorities with the power to temporarily prohibit redemptions, but only when an insurer is in financial distress. The insurance industry was also supportive but there were mixed views as to under which situations the powers should be exercised. The majority of respondents supported providing public authorities with power to reduce entitlements of insurer's clients, but only as a last resort measure. Participants also acknowledged the necessity to strengthen macro-prudential supervision in Solvency II but only in certain areas, while the insurance industry supported to limit the measures only to the areas covered by the Commission's call for advice, as going further that those areas would jeopardize the international competitiveness of the European insurance industry in their view. Moreover, the civil society was the only stakeholder group supporting regulatory flexibility in adverse events. Some recommendations included removing eligibility limits on lower-quality capital, providing reporting flexibility and recalibrating requirements during crises.

5.4. New emerging risks and opportunities

5.4.1. European Green Deal and sustainability risk

The civil society deemed as very important the requirement for climate scenario analyses as part of the risk management and governance requirements ("Pillar 2") rules. Public authorities were also supportive but gave various levels of importance, while only a few insurance stakeholders supported that climate scenario analyses are of high or medium importance. Some recommendations included lowering the risk margin and capital requirements for long term investments and strengthening insurers' advisory role towards clients in regards to climate resilience and adaptation.

5.4.2. Digitalisation and other issues

The insurance industry was mainly against having additional requirements for monitoring ICT risks (80%), as part of the prudential framework. The civil society was mainly in favour (86%), by pointing out the need to reflect those risks given the current outlook of digitization and the increasing threat of cyber-attacks. Furthermore, the insurance industry was against having cyber insurance as a distinct class, while the public authorities were in favour (75%).

5.4.3. Group-related issues

The insurance industry mainly supported (86%) providing lighter requirements for intra-groups and distinguishing between intra-group and extra-group outsourcing, but subject to additional criteria. Some recommendations on the additional criteria include taking into account proportionality, risk exposure and the need for clear harmonized criteria. Public authorities largely opposed this proposal (86%), while the civil society had mixed views, with the majority opposing the proposal. The majority of participants (80%) thought it is unacceptable that group supervision waives solo supervision in certain circumstances.

5.5. Additional or late feedback to the consultation

Stakeholders were offered the opportunity to make an attachment to their contribution, in order to cover any topic or provide any complementary information that they would deem useful. 31 stakeholders provided such inputs. Most of them aimed at expanding or

clarifying the stakeholder's point of view on certain areas of the consultation. Some contributions, mainly from stakeholders classified as "other businesses" (non-insurance related), also touched upon additional topics not covered by the consultation document. However, each of those specific issues was only raised by a couple of participants to the public consultation. Those topics include, although not limited to, the following:

- group supervision issues, including the prudential treatment of insurance subsidiaries headquartered in third countries, and the generalization of the use and disclosure of Legal Identity Identifiers;
- market access of third country companies which exclusively conduct reinsurance activities;
- the prudential treatment of derivatives, securitisation, exposures to central counterparties, and credit and suretyship insurance business;
- the definition of the insurance business in view of financial innovations.

Two additional feedbacks, from a non-governmental organisation (NGO) and the European Systemic Risk Board (ESRB) were received in the context of the public consultation. An analysis for the two individual responses is presented below, while it is important to highlight that the answers were not included in the statistics of the Public Consultation.

The feedback received from the ESRB focused on macro prudential considerations, recovery and resolution, as well as appropriate reflection of risk in the prudential framework. For better reflecting macro prudential considerations, the ESRB provided recommendations for introducing three types of tools to the framework: solvency tools, liquidity tools and tools for addressing risks from financing the economy. In addition, the ESRB called for a harmonized recovery and resolution framework across the EU and improved harmonization of the IGS. In order to ensure that risks are reflected properly in the Solvency II, the ESRB recommended to adjust the risk-free rate term structure to better reflect the current low interest rate environment. In the context of the Covid-19 crisis, ESRB called for coordinated responses during crises, highlighted the need for a capital buffer, called for a reflection of volatility in insurers' solvency ratios and finally stressed the need for a better monitoring of liquidity and supervisory intervention.

The feedback received from the NGO is mainly in line with the views provided to the public consultation by the civil society. The respondent opposed preferential treatment for "green investments" and highlighted the need to reflect the current low interest rate environment, while opposing the offering of guaranteed products. In addition, the participant supported considering the audience when preparing the SFCR and providing a shorter and simpler version for policyholders. Regarding the IGS, the respondent was in favour of minimum harmonization and at the same time considering the national differences between member states and also pointed out the need for better recovery and resolution. Finally, the respondent acknowledged the need to reflect IT risks in insurers' management practices.

6. TARGETED CONSULTATIONS OF MEMBER STATES

The Commission services discussed the different aspects of the review of Solvency II during several Expert group meetings with Member States on Insurance matters:

- On 29 March 2019, Member States were consulted on the overall scope and process of the review
- On 30 September 2019, there was an exchange of views between EIOPA and Member States about EIOPA's draft consultation document. Member States were

also asked to provide feedback on the Commission's finding in its report on group supervision which was published in June 2019

- On 19 February 2020, Member States were invited to comment on the European Commission's consultation strategy, but also EIOPA's approach to the impact assessment of its proposals. A specific debate took place on the Commission's approach in relation to recovery and resolution and to insurance guarantee schemes.
- On 26 May 2020, Member States were asked whether the Covid-19 outbreak required urgent changes to the framework, ahead of the Solvency II review. The majority view was that the situation of the insurance sector appeared so far stable and under control and that quick fixes were not needed. However, it was agreed that a careful monitoring of market developments would be needed in close cooperation with EIOPA.
- On 10 November 2020, the Commission services asked feedback to Member States about the priorities of the review, including the main problem that the initiative should aim to tackle and the objectives of the review of Solvency II. In addition, the European Commission shared the preliminary results of the feedback to its public consultation, which was followed by a debate. The European Commission also consulted the Member States on specific elements related to recovery and resolution.
- On 16 December 2020, the Commission services invited Member States to provide their views on the possible technical features for insurance guarantee schemes
- Finally, on 1 February 2021, the Commission services invited Member States to provide their views on the main components of EIOPA's advice: The Capital Markets Union and the Sustainable Finance Strategy, risk sensitivity and volatility, proportionality, quality of supervision and finally systemic risks.

In addition, Member States were consulted specifically on recovery and resolution and on IGS items through a targeted survey that was circulated following the 19 February 2020 meeting. Member States were also asked to complete a template on the design and funding of existing IGS schemes following the 16 December 2020 meeting.

The input provided by Member States has been integrated throughout the impact assessment.

ANNEX 3: WHO IS AFFECTED AND HOW?

1. PRACTICAL IMPLICATIONS OF THE INITIATIVE

The objective of this Annex is to set out the practical implications for the main stakeholders affected by this initiative, mainly the insurance sector and their shareholders, supervisory authorities and consumers. The initiative aims to simultaneously address the following problems:

- **Problem 1**: Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy
- **Problem 2**: Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of insurers' solvency position
- **Problem 3**: Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs
- **Problem 4**: Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures
- **Problem 5**: Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

In order to address the issue of **limited incentives for insurers to contribute to the long-term financing and the greening of the European economy** (Problem 1), the preferred options are to facilitate long-term investments in equity by revising the eligibility criteria of the existing regulatory asset class for long-term equity investments (Option 2) and to strengthen "Pillar 2" requirements in relation to climate change and sustainability risks (Option 4) without changing capital requirements depending on the green/brown nature of investments.

Insurers and their shareholders would benefit from those options, as insurance companies by being allowed to take additional risks (i.e. investing more in equity) with limited impact on capital requirements, would be in a position to generate a higher return on investments to their shareholders at limited additional costs. They would be also incentivised to better integrate climate change and sustainability risks in their investment and underwriting practices, which increases compliance costs but strengthens the risk management system of insurance companies. Also, in the long run, insurance companies and their shareholders would benefit from this enhanced monitoring and management of sustainability risks. Even in the short run, the implementation costs of those options (both one-off and ongoing) would be moderate.

Policyholders would also benefit from a higher level of protection due to better management of environmental and climate risks in insurers' investment and underwriting activities. This means that the risk of insurance failure due to those risks would be reduced. They may be more exposed to the likely increase risk-taking by insurance companies as a result of the changes on the treatment of equities[108], but they would also benefit from such a change in investment strategy through the possibility for insurance companies to provide higher returns through profit-sharing mechanisms with policyholders.

Supervisors would also benefit from clearer and less complex rules in relation to both equity and climate change risks.

[108] This risk is however limited as the criteria would be framed broadly in line with EIOPA's advice, which guarantees a prudent approach.

Finally, businesses, in particular SMEs and those conducting green activities, would benefit from easier access to funding by insurance companies thanks to those options, as the prudential framework would be more conducive of long term investments, while at the same time ensuring that insurers appropriately capture the longer-term risks of climate change.

Next to this, the overall society welfare could increase in case the proposed options would result in a significant change in insurers investment activities in the directions envisaged. In this case, both the economy would grow stronger and negative effects on the environment by investments by insurers would be mitigated. Clearly, in case insurance companies would make too risky equity investments this could undermine policyholder protection and also possibly financial stability.

In order to address the issue of **insufficient risk sensitivity and limited ability of the framework to mitigate volatility of insurers' solvency position** (Problem 2), the preferred option is to address issues of risk sensitivity and volatility while balancing the cumulative effect (on capital requirements) of the changes (Option 3). This implies in particular better reflecting the low-interest rates environment in capital requirements and in the valuation of insurers' long-term liabilities towards policyholders, but also ensuring that the mechanisms aiming to mitigate volatility (notably the volatility adjustment) are fit for purpose. However, in order to ensure that the overall impact of those changes remains balanced (and does not become market disruptive), the changes would be only progressively implemented over time (phasing-in periods) and the changes affecting insurer's capital ratio negatively would be compensated by additional changes which would have a positive effect on insurers' solvency ratio, notably the reduction of the cost-of-capital rate underlying the risk margin calculation from 6% to 5%. Overall, the implementation of Option 3 would lead to an increase in capital surplus.

The implementation of Option 3 would largely benefit policyholders, as insurers would more appropriately capture in capital requirements a material risk to which they are exposed and which is currently underestimated under standard formula capital requirements. They would also benefit from the reduced volatility of the framework, as insurers would be in a better position to offer products with guarantees and less incentives to simply shift market risks to policyholders. The improved mitigation of volatility is also contributing to insurers' international competitiveness which can follow a longer-term approach when making decisions of international expansion.

Option 3 would also benefit insurers, thanks to the mitigated volatility and the greater ability to make long-term decisions. Obviously, the tightening of rules in relation to interest rates (although partly compensated) would be a cost for insurers' shareholders. However, this cost remains moderate and justified by the need to better capture a material macroeconomic risk to which insurers are exposed. In addition, they would be given time to implement those changes due to the introduction of a phasing-in. Finally, there would be implementation costs as the new framework would be more complex than under current rules. However, the additional level of complexity stemming from Option 3 is such that it tries to strike a balance between the need to improve the technical robustness of the framework and the objective of avoiding excessive complexity of prudential rules.

Finally, Option 3 would affect supervisors as they would have to ensure that insurers comply with a more complex framework. In addition, during the phasing-in period, they would have to carry out additional monitoring activities in order to ensure that insurers are managing the risks stemming from the low-yield environment even if not fully integrated in capital requirements in the short run.

In order to address the issue of **insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs** (Problem 3), the preferred option is to give priority to enhancing the proportionality principle within to Solvency II and make a lower change to the exclusion thresholds than what is proposed by EIOPA (Option 3). Concretely speaking, the threshold of exclusion from Solvency II in relation to volume of business activities would be multiplied by two as proposed by EIOPA (from € 25 million to € 50 million), but the threshold in relation to revenues would be multiplied by three and not by five as proposed by EIOPA (from € 5 million to € 15 million). In addition, the eligibility criteria for classification as "low-risk profile insurer" would be slightly less strict than under EIOPA's proposals with the aim of allowing more firms to automatically benefit from a list of proportionality measures, which would also be slightly extended compared to what EIOPA proposed (notably in relation to public disclosure requirements).

Option 3 would generate material reduction in compliance costs for the estimated 186 insurance companies which would no longer be subject to Solvency II. Unless they want to benefit from the "passporting" or they are required to comply with Solvency II under national law, they would not be required to comply with any Solvency II requirement which would generate a reduction of 2.2% of operating costs. Obviously, this benefit would be partly compensated by the cost of implementing national prudential rules (including the one-off cost of changing IT systems and the sunk costs of developing systems to comply with Solvency II), which cannot be quantified. In addition, at least 249 insurers would be classified as low-risk profile and as such would benefit from automatic proportionate rules. For those firms, this would result in an immediate benefit and reduction of compliance costs, which cannot be clearly quantified although it can be estimated to be above 0.2% of total operating expenses, taking into account the reduced frequency of submission of narrative reporting to supervisors.

Policyholders could benefit from the reduced compliance costs as it would imply higher ability for insurers to innovate and supply policyholders with a well-diversified range of insurance products. Shareholders might benefit from higher profits. The reduced level of public disclosure for insurers that are low-risk profile would imply lower transparency towards specialised stakeholders (financial market participants, analysts). However, the insurers concerned would still represent a minor share of total insurers' liabilities towards policyholders (0.06%) or insurers' revenues (0.07%). Therefore, the loss of information is expected to have a limited impact.

For supervisors, Option 3 would imply that additional insurers would be subject to national prudential rules, which means that supervisory authorities would have to maintain competencies so that supervisors have knowledge on both Solvency II rules and national prudential rules. Solvency II supervisors would also have to adapt from less frequent of regular supervisory reports and own risk and solvency assessment reports by low-risk profile insurers which would reduce the information received to exercise ongoing supervision. In addition, in the short run, supervisors would receive and have to process a high number of notifications from insurers that want to be classified as low-risk profile and indicate which proportionality measures they intend to use, which represents a material one-off cost. Finally, EIOPA would also receive less information (as insurers excluded from Solvency II would no longer report in accordance with the Solvency II quantitative reporting templates). However, this should have limited impact on EIOPA's ability to monitor market trends and the arising of systemic risk in the insurance sector due to the very limited market shared that the excluded insurers would represent.

In order to address the issue of **deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures** (Problem 4), the preferred options are to improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border and to group supervision (Option 2), to introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner (Option 3) and to introduce minimum harmonising rules to protect policyholders in the event of an insurer's failure (Option 4).

The main beneficiaries would be policyholders. Option 2 would ensure that the quality and consistency of supervision, including for cross-border insurers, is improved, while Options 3 and 4 would ensure that the (near-)failure of an insurer is appropriately managed and that policyholders are protected in case an insurer fails. More precisely, the (further) harmonised recovery and resolution framework would contribute to reducing the negative social and welfare impact of an insurer's failure. The minimum harmonisation of IGSs would not only safeguard the confidence of consumers in the Single Market but would also contribute to market discipline, as the insurance guarantee scheme of the Home Member State of the failing insurer would be used to compensate policyholders of that insurer. Progressive ex-ante funding of IGSs (over a 10-year period) would imply a maximum annual contribution of around 0.233% of gross written premiums by each contributing policyholder (i.e. about EUR 2.33 per yearly policy of EUR 1000) which appears to be, in absolute terms, a moderate cost to ensure an adequate level of protection in case of insurance failure[109].

Insurers would also benefit from clearer rules and improved level-playing field stemming from those options. They would also be better prepared to react to a deterioration in their solvency position. The ex-ante funding of IGS would have a capital cost, which, in absolute terms, appears to be moderate – the Commission services estimate it to be 0.12% of annual premiums[110].

Finally, supervisors would benefit from those changes, with more legal clarity and a better preparedness for insurers' financial distress. On the other hand, the enhanced quality of cross-border supervision and the new planning requirements imply that supervisory authorities allocate sufficient resources to such new activities, although those additional costs remain contained.

Finally, in order to address the issue of **limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector** (Problem 5), the preferred option is to make targeted amendments to prevent financial stability risks in the insurance sector (Option 2). More concretely, supervisors would be granted new supervisory powers and insurers would have to comply with some new requirements aiming to prevent the build-up of systemic risks stemming from or amplified by the insurance sector, which could be detrimental to financial stability. This would include in particular ensuring that insurers better incorporate macro-prudential considerations in their investment and risk management activities, enhancing liquidity requirements on insurers and introducing the power for supervisors to temporarily freeze redemption rights on life policies, aligning prudential rules on loan origination with the banking sector, and granting supervisors the possibility to suspend or restrict dividend distributions of specific firms in exceptional situations for financial stability reasons.

[109] See Annex 5 for the assumptions underlying the estimation of costs.
[110] Assuming a cost-of-capital rate of 5% as suggested in Section *6.2* of the impact assessment.

Policyholders would benefit as improved financial stability would have no direct effect on policyholder protection in the short run but could benefit them in the long run as the risk of insurance failures would decline. In addition, financial instability risks and possible spill-over effects on the real economy could affect policyholders both as taxpayers (since business failures and economic recession may require public intervention) and as workers (since EIOPA demonstrates that there is a correlation between financial instability and unemployment). In addition, while some of the tools embedded in Option 2 may seem harmful to policyholders in the short term if used (e.g. the power for NSAs to freeze the exercise of surrender options on life insurance contracts), they would be a last resort measure to avoid the failure of an insurer, which may result in financial losses for policyholders in the longer run.

Option 2 would have a cost for insurers' shareholders because of the possibility of dividend restrictions in exceptional situations. However as such restrictions may strengthen the solvency position of insurers and thus their probability of survival, shareholders would benefit from those measures in the medium term. Similarly, insurers conducting banking-type loan origination activities may face a slight increase in capital requirements due to a convergence with banking rules but this might benefit the economy as the risk of not adequately regulated shadow banking is reduced. Also, insurers would be less prone to liquidity risks, both because they would be required to better plan for liquidity risk and due to the last-resort possibility to freeze redemption rights. Of course, liquidity planning is an additional compliance cost, but this cost is supposed to be limited as insurers are already expected to monitor and manage liquidity risk as part of the own risk and solvency assessment (ORSA). The other implementation costs in relation to the enhanced risk management and reporting system are also expected to be moderate as a number of insurers already embed such requirements in their processes, and the costs for those which do not apply it yet would remain limited.

Finally, Option 2 would also strengthen the power and duties of supervisory authorities in relation to financial stability. This slight increase in supervisory costs is fully justified by the fact that preserving financial stability is an explicit objective of the Solvency II framework, and generates overall welfare gain (when compared with a counterfactual financial stability crisis).

The following tables summarize the impact of the different preferred options.

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Baseline: Do nothing	0	0	0
Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy			
Option 2: Facilitate long-term investments in equity	++	+/-	+
Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	-	+++	+
Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies			
Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes	+	++	-
Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers			
Option 3: Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.	++	-	-
Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures			
Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision	+/-	++	+/-
Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner.	+/-	++	+
Option 4: Introduce minimum harmonising rules to protect policyholder in the event of an insurer's failure	-	+++	0
Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector			
Option 2: make targeted amendments to prevent financial stability risks in the insurance sector	+/-	+	+/-

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volatility	Proportionality	Supervision - protection against failures	Financial stability		
Baseline: Do nothing	0	0	0	0	0	0	**0**	**--**
Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy								
Option 2: Facilitate long-term investments in equity	++	-	-	0	+	-	++	++
Option 4: Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	+	0	0	0	+	++	**+**	**++**
Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies								
Option 3: Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes	+++	++	+++	-	-	++	++	++
Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs for small and less complex insurers								
Option 3: Give priority to enhancing the proportionality principle within Solvency II and make a smaller change to the exclusion thresholds.	0	0	0	+++	-	-	**++**	**+**
Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures								
Option 2: Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision	+	+	0	0	++	+	**++**	**++**
Option 3: Introduce minimum harmonising rules to ensure that insurance failures can be better averted or managed in an orderly manner.	0	0	0	+	++	++	**++**	**++**
Option 4: Introduce minimum harmonising rules to protect policyholder in the event of an insurer's failure	+	0	0	0	+++	+	**++**	**++**
Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector								
Option 2: make targeted amendments to prevent financial stability risks in the insurance sector	-	+	0	+/-	--	++	**+**	**++**

2. SUMMARY OF COSTS AND BENEFITS OF THE COMBINED SET OF OPTIONS

I. Overview of Benefits (total for all provisions) – Preferred Combination of Options		
Description	*Amount*	*Comments*
	Direct benefits	
Improved ability to contribute to the long-term financing of the economy	By facilitating the use of the long-term equity asset class that is subject to a preferential capital treatment, and by mitigating insurers' volatility in solvency ratio, the review would incentivise long-termism in underwriting and investment decisions. Insurers would find it less costly to make long-term investments in equity. As a minimum EUR 22 billion of additional equities would be eligible to the preferential treatment according to EIOPA's Impact Assessment. In addition, as the changes which would result in stricter capital requirements (changes on interest rates) would only be progressively implemented (phasing in), in the first years of implementation of the review, up to EUR 90 billion of capital resources in excess of capital requirements would be released in the short-term compared to current rules. This could help insurers' contribute to the economic recovery.	Insurers are the main recipients of this benefit. The quantification of the impact by EIOPA was complex due to limited feedback from stakeholders. As there are still conditions attached to the benefit of using the long-term equity asset class, the extent of its use depends on the willingness of insurers to comply with the criteria (notably the willingness to invest for the long-term). The additional equities that are eligible would imply a lower total capital charge for equity investments (see next row) which may be further invested in equity).
More robust risk management requirements concerning climate and sustainability risks	Increased understanding of climate and environmental risks by insurance companies and decisions by insurers will have to reflect those risks.	Stakeholders who benefit: • Policyholders; • Beneficiaries; • Investors in insurance companies.
Harmonised approach to management and supervision of climate and environmental risks	Clarified "Pillar 2" rules would provide a harmonised set of rules for the integration of climate and environmental risk across the EU and avoid diverging practices in implementation and supervision.	Stakeholders who benefit: • insurance companies, in particular those that are part of an insurance group with insurers in several Member States; • supervisory authorities.

International competitiveness is preserved or even improved	This benefit is driven by several factors: - Better reflection of insurers' long term business model which facilitates long-termism in investment decisions (reduced capital charges on long-term equity investments) and underwriting activities (better mitigation of the impact of short-term volatility. - Taking into account the temporary impact of the phasing of changes on interest rates, the insurance sector would start with an increase in capital resources in excess of capital requirements of up to EUR 90 billion compared to capital resources under current rules right after the review (assuming similar economic conditions as at the end of Q2/2020). While the sector's capital resources would increase during the most important period for the post-Covid economic recovery, this increase in capital resources would reduce during every year of the phasing in period. At the end of the phasing in period, the preferred recommendations would still maintain an estimated increase in capital resources by EUR 30 billion at EU level in an economic environment similar to that at end of Q4/2019. If the economic environment is similar to that at the end of Q2/2020, FISMA's proposal would lead to an increase in capital resources of EUR 16 billion at the end of the phasing in period (to be compared with a decrease by EUR 55 billion under EIOPA's advice). - By strengthening more macro-prudential requirements without imposing undue capital burden (e.g. no supervisory power to impose capital surcharge for systemic risk) insurers would be better prepared to cope with the next financial crises.	Insurers would be the main recipients of this benefit. This also contributes to
Enhanced policyholder protection	This is achieved through the following: - Enhanced risk sensitivity: The framework would better capture the protracted low and even negative interest rates environment in standard formula capital requirements and in the valuation of insurers' liabilities towards policyholders - Clearer and more effective rules on group supervision - Higher quality of supervision, and better coordination by EIOPA - Reduced likelihood of insurers' failures: By clarifying the preventive powers and ensuring an adequate degree of preparedness, on both the industry and the supervisory sides, EU action would contribute to increasing the likelihood that an insurer in distress would effectively restore its financial position and continue to perform its functions for society. - Reduced losses in social welfare stemming from the failure of an insurer: the default of insurance companies can expose policyholders to substantial social and financial hardship due to the discontinuation of their policies and the resulting absence of protection. These effects would be mitigated through a minimum harmonised recovery and resolution framework. Complemented by the implementation of a minimum	The main recipients are policyholders who would benefit from enhanced policyholder protection. This would also benefit insurers, which would have stronger incentives for robust risk management in relation to interest rate risk.

	harmonisation of IGS across the EU, the framework would ensure a minimum level of protection throughout the Single Market, thereby ensuring a fair and equal treatment of all policyholders, whatever their place of residence. - In relation to macro-prudential tools, the greater focus on macroprudential concerns in underwriting and risk management activities, and on liquidity risks, would reduce incentives for excessive risk taking by insurers and therefore contribute to policyholder protection.	
Enhanced level-playing field and improved competition within the Single Market for insurance services	This is achieved through the following: - More consistency in supervision through clearer rules which are applied more consistently in the different Member States. - Reduction in undue regulatory burden: The high cost of compliance of Solvency II is a barrier for new entries in the sector. By reducing the cost of compliance of the small and less risky insurers, it will be a reduction of the operating costs that will contribute to enhancing the profitability of the SME in the EU. - Rules on group supervision would also ensure that non-EEA groups operating in Europe are not put at a competitive advantage by circumventing Solvency II rules on group supervision. - In relation to recovery and resolution, the EU action would foster the level-playing field and competitiveness in the insurance industry across the EU. Competitive distortions between domestic and non-domestic insurers will be reduced, thereby contributing to a more efficient Single Market for insurance. In addition, the harmonisation of the geographical scope of IGSs would also eliminate overlaps of existing IGSs as well as the associated costs.	Policyholders will benefit from a well-diversified offer of products coming from traditional firms and from new players.
Compliance cost reductions by way of exclusion from Solvency II and by way of enhancement of proportionality measures for insurers in the	According to EIOPA's Impact Assessment, by extending the threshold of exclusion from Solvency II, a maximum of 186 insurers would be excluded from Solvency II. This could represent a reduction in ongoing compliance cost of up to EUR 500 million. The expected number of insurers concerned would be in the range between 249 and 435, the latter in case the existing exclusion thresholds from Solvency II were not updated by Member States. For those insurers, automatic proportionate rules would apply, which could reduce ongoing compliance costs, up to EUR 50 million, according with the estimations of the Commission Services.	The recipients of this benefit are insurers. Considering that some Member States may decide to keep the current exclusion thresholds, the number of insurers which may be actually excluded could be lower than 186. Besides, some insurers may prefer to continue under Solvency II, notably in order to benefit from the passporting regime. NB: more firms than the estimates provided could benefit from proportionality measures within

scope of solvency II		Solvency II, but conditioned to approval by the supervisor (case by case analysis).
Enhanced policyholder protection	Clearer and simpler criteria to be met to use the long-term equity asset class	More legal certainty for supervisors in supervising the use of the long-term equity asset class.
Prevention of risks for the financial stability	This is achieved through the following: - More powers for supervisors in relation to macro-prudential supervision - Harmonising rules in relation to resolution: EU action would ensure the continuity of functions by insurers whose disruption could harm financial stability and/or the real economy and to protect public funds (by limiting the risk of needing to "bail-out" failing insurers).	Recipients of this benefit are citizens and businesses at large as well as national governments (less likelihood to involve taxpayer's money to address the consequences of a financial crisis).
Indirect benefits		
Indirect incentives for an increase in sustainable investments	More robust risk management requirements concerning climate and sustainability risks provide indirect incentives for sustainable investments and for divestments from environmentally harmful assets. This may result in a reduction of greenhouse gas emissions. In addition, certain studies show that equity investments are more conducive to the greening of the economy. Therefore, fostering equity investments could positively affect insurers' financing of the green transition.	Stakeholders who benefit: • investees with sustainable activities; • policyholders with sustainable activities; • any parts of society that might be affected by the negative impacts of climate change.
More access to capital financing by SMEs	As capital charges on unlisted equity (i.e. including those from SMEs) are higher than those on listed equities (few SMEs are actually listed), the benefit of being classified as long-term equities is even bigger for unlisted equities. Therefore, this will provide additional incentives for insurers to invest in unlisted equity.	SMEs will be indirect beneficiaries of the revised criteria for long-term investments.

II. Overview of costs – Preferred Option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Costs	Direct	During the "phasing in" of changes on interest rates, policyholder protection in relation to interest rate risk would not be fully guaranteed.	In relation to IGSs, assuming pre-funding, while the costs are primarily borne by insurance companies, a proportion of them will likely be passed on to policyholders. Therefore, a maximum estimate is that, during the build-up phase (assumed to be 10 years), the costs could be around EUR 2.33 for a yearly premium of EUR 1,000.	**Implementation of new requirements including on planning – those costs are expected to be low (e.g. only 0.46 FTE for liquidity planning, 0.06% of all employees). ** For insurers excluded from Solvency II, switching costs and compliance costs of the national regime. As an insurer can	** Changes on interest rates may increase capital costs for life insurers by more than EUR 48 bn (but compensating measures on volatility adjustment and risk margin would be introduced to reduce the impact) ** While the review is balanced in terms of capital surplus, it would result in a slight decrease (though very moderate considering the currently very high level of SCR ratios) in the solvency ratio of insurers : less than 3 percentage points at EU level. ** In relation to IGSs, if the costs are not passed on to policyholders, the maximum cost estimate for the insurance industry could be around EUR 21 billion over a transition period of 10 years. This would represent a yearly capital cost of 0.12% of gross written premiums. ** In relation to group supervision, certain	**During the phasing-in period where capital requirement do not fully reflect the actual risks from the protracted low-yield environment, need to monitor insurers' behaviour to ensure that there is no excessive risk-taking. **One-off cost of adapting supervision to the new rules – those costs are expected to remain low. ** increased budget dedicated to hiring and training supervisors in charge of insurers subject to national rules. ** A wave of submission of application for proportionality measures would have to be processed by supervisors in a short timeframe.	**The supervision of new rules (e.g. the volatility adjustment) would become slightly more complex. Those costs are expected to be low. ** Regular training so that supervisors remain knowledgeable of two sets of rules (Solvency II and national ones) – those costs are expected to remain low. **Ongoing monitoring of the proportionality measures applied by insurers (this cost is expected to remain

				always decide to remain under Solvency II, the switching costs would be implemented only if national rules are less burdensome. **Need to submit notification/application in order to benefit from proportionality measure – this cost is low compared to the benefit of applying proportionate measures for the firms concerned.	measures taken in isolation may result in higher capital costs for certain groups. However, overall, the review is balanced. ** Some rules , notable on volatility adjustment, would be slightly more complex to implement. Those implementation costs are expected to remain low. ** Insurers would be required to maintain the new plans (on recovery and on liquidity) – those costs are expected to remain moderate – e.g. 0.41 FTE for liquidity planning = 0.05% of total employees. ** For insurers excluded from Solvency II, ongoing compliance costs with national rules. Note that it is expected that an insurer would be under national rules if those rules prove to be less burdensome than Solvency II. **Need to regularly report on the proportionality measures used – This cost is low compared to the benefit of applying more proportionate measures.	** New framework on recovery and resolution would require additional human resources (up to 9 FTE and EUR 450,000) – Those costs remain moderate. ** In relation to IGSs Member States where no IGS is in place would face set-up costs. For Member States where an IGS is already in place, the costs would depend on the elements of design and scope that would need to be adapted.	low. ** Intensified cross-border supervision and more requirements on cooperation would increase costs for supervisory authorities which are currently not dedicated enough resources to cross-border activities. ** New framework on recovery and resolution would require additional human resources (up to 9 FTE and EUR 450,000) – Those costs remain moderate.

	Indirect		Part of the increase capital or compliance costs may be partly shifted to customers through higher premiums.			** The “phasing in” of some measures would generate monitoring (but low) costs. ** In rare cases, insurers may be required to implement measures to address any identified impediments to resolution.	

3. SUMMARY OF COSTS AND BENEFITS PER PROBLEM

3.1. Problem 1: Limited incentives for insurers to contribute to the long-term financing and the greening of the European economy

PREFERRED OPTION: FACILITATE LONG-TERM INVESTMENTS IN EQUITY

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Improved ability to contribute to the long-term financing of the economy	By facilitating the use of the long-term equity asset class that is subject to a preferential capital treatment, insurers will find it less costly to make long-term investments in equity. As a minimum EUR 22 billion of additional equities would be eligible to the preferential treatment according to EIOPA's impact assessment.	Insurers are the main recipients of this benefit. The quantification of the impact by EIOPA was complex due to limited feedback from stakeholders. As there are still conditions attached to the benefit of using the long-term equity asset class, the extent of its use depends on the willingness of insurers to comply with the criteria (notably the willingness to invest for the long-term). The additional equities that are eligible would imply a lower total capital charge for equity investments (see next row) which may be further invested in equity).
Reduction in overall capital requirements	By facilitating the use of the long-term equity asset class, all else equal, the measure would reduce capital requirements by at least € 3 billion (all else equal).	Insurers would be the main recipients of this benefit. Even if insurers do not invest more in equity, they would benefit from a decrease in capital requirements by extending their use of the long-term equity asset class.
More effective supervision	Clearer and simpler criteria to be met to use the long-term equity asset class.	More legal certainty for supervisors in supervising the use of the long-term equity asset class.
International competitiveness	Reduced capital charges on long-term investments in equity improves the excess capital over capital requirements of EU insurers, which facilitates international expansion (either by selling new products with guarantees in foreign markets or by acquiring new foreign subsidiaries).	The main recipients of this benefit are insurance companies.
Indirect benefits		
More incentives to contribute to the greening of the economy	As green investments require more long-term financing, and capital financing is more effective than debt financing in achieving a reduction of greenhouse gas emissions[111], the	Insurers are the main recipients of this benefit.

[111] See e.g. European Central Bank, Research Bulletin No. 64, "Finance and decarbonisation: why equity markets do it better", 27 November 2019 (link).

	incentives for insurers to make more long-term investments in equity also provides indirect incentives in long-term and green investments in the form of equity.	
More access to capital financing by SMEs	As capital charges on unlisted equity (i.e. including those from SMEs) are higher than those on listed equities (few SMEs are actually listed), the benefit of being classified as long-term equities is even bigger for unlisted equities. Therefore, this will provide additional incentives for insurers to invest in unlisted equity.	SMEs will be indirect beneficiaries of the revised criteria for long-term investments.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Review the eligibility criteria for long-term investments in equity	Direct costs		Slight reduction in the level of policyholder protection compared to current rules[112]	Compliance costs to ensure eligibility criteria for long-term equity investments are met		Supervision of insurers' compliance with new criteria for long-term equity investments	
	Indirect costs						Monitoring of the impact of the new rules on insurers' risk taking activities and on financial stability risks by supervisors

PREFERRED OPTION: STRENGTHEN "PILLAR 2" REQUIREMENTS IN RELATION TO CLIMATE CHANGE AND SUSTAINABILITY RISKS

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
More robust risk management requirements concerning climate and	Increased understanding of climate and environmental risks by insurance companies and decisions by insurers will have to reflect those risks.	Stakeholders who benefit: • Policyholders; • Beneficiaries; • Investors in insurance companies

[112] This is due to the fact that according to EIOPA, the 22% capital charge is not supported by evidence. However, the reduction in policyholder protection is deemed limited as the revised eligibility criteria for long term investments in equity would be broadly in line with EIOPA's general approach on this issue.

sustainability risks		
Harmonised approach to management and supervision of climate and environmental risks	Clarified "Pillar 2" rules would provide a harmonised set of rules for the integration of climate and environmental risk across the EU and avoid diverging practices in implementation and supervision.	Stakeholders who benefit: • insurance companies, in particular those that are part of an insurance group with insurers in several Member States; • supervisory authorities.
Indirect benefits		
Indirect incentives for an increase in sustainable investments	More robust risk management requirements concerning climate and sustainability risks provide indirect incentives for sustainable investments and for divestments from environmentally harmful assets. This may result in a reduction of greenhouse gas emissions;	Stakeholders who benefit: • investees with sustainable activities; • policyholders with sustainable activities; • any parts of society that might be affected by the negative impacts of climate change.
Positive contribution to financial stability	By strengthening "Pillar 2" requirements in relation to sustainability risks, insurers would be more resilient to climate and sustainability risks, which may materialise over the long run and impact significant parts of the sector at the same time.	A better prevention and management of the systemic nature of climate change would benefit the society and the economy at large and thereby also insurers.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks	Direct costs	None	Increase in insurance premiums due to implementation cost that insurers eventually pass on to consumers	Need to build up capacity on climate and environmental risk management	Less than EUR 200 000 per annum and entity for compliance [113]	Need to build up capacity on supervision of climate and environmental risk management	Need to maintain capacity on supervision of climate and environmental risk management
	Indirect costs	None	None	None	None	None	None

3.2. Problem 2: Insufficient risk sensitivity and limited ability of the framework to mitigate volatility of insurers' solvency position

PREFERRED OPTION: ADDRESS ISSUES OF RISK SENSITIVITY AND VOLATILITY WHILE BALANCING THE CUMULATIVE EFFECT OF THE CHANGES

I. Overview of Benefits (total for all provisions) – Preferred Option

[113] See SWD(2018) 264, page 47 (link) and explanations provided in section 6.1.3.

Description	*Amount*	*Comments*
	Direct benefits	
Improved ability to contribute to the long-term financing of the economy	The reduced volatility of the framework would incentivise long-termism in underwriting and investment decisions by insurers. In addition, as the overall impact of the review in terms of quantitative requirements would be balanced (limited decrease in capital surplus), there would no longer be any hindrance to further investments by insurance companies.	Insurers would be the main recipients of this benefit.
Reduced volatility in solvency position of insurance companies	Short-term volatility would be significantly mitigated, and the framework would address the issues of overshooting and undershooting as described in the evaluation annex. Solvency ratios would become more stable	Insurers would be the main recipients of this benefit.
Enhanced risk sensitivity	The framework would better capture the protracted low and even negative interest rates environment in standard formula capital requirements and in the valuation of insurers' liabilities towards policyholders	The main recipients are policyholders who would benefit from enhanced policyholder protection. This would also benefit insurers, which would have stronger incentives for robust risk management in relation to interest rate risk.
Improved international competitiveness	The reduced volatility of the framework would foster long-termism in investment and underwriting activities. More stable solvency ratios also facilitate business planning and strategic planning (notably for international expansion). In addition, the review is more than balanced in terms of capital requirements and would release between EUR 16 billion and EUR 30 billion of capital depending on the market conditions.	Insurers would be the main recipients of this benefit
Lower capital requirements in the short term	Due to the phasing-in of the changes on interest rates which have a negative impact over at least 5 years, as changes with a positive impact would apply from day 1, this would lead to a short term significant improvement in insurers' solvency position (up EUR 90 bn in capital resources in excess of capital requirements).	Insurers would be the main recipients of this benefit
	Indirect benefits	
Positive contribution to financial stability	The reduced volatility of the framework would avoid procyclical behaviour by insurance companies in stressed situations. Similarly, by better capturing the low interest rate environment, the framework would reduce the risk of excessive risk taking by insurers which would be incentivised to have robust risk management and asset-liability management strategies.	Recipients of this benefit are citizens and businesses at large as well as national governments (less likelihood to involve taxpayer's money to address the consequences of a financial crisis).

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Adapting the framework to address volatility	Direct costs			More complexity to comply with new calculation approach of the volatility adjustment. Still, limited implementation cost		Increased complexity will require resources to supervise the appropriate application of new rules	
	Indirect costs						
Adapting the framework to improve risk sensitivity	Direct costs			Need to adapt IT systems every year in the short term in view of the progressive implementation of new rules during the phasing-in period.	Slight decrease in solvency ratios (around 2 percentage points) due to a better reflection of the low-yield environment	During the phasing-in period where capital requirement do not fully reflect the actual risks from the protracted low-yield environment, need to monitor insurers' behaviour to ensure that there is no excessive risk-taking	
	Indirect costs						

3.3. Problem 3: Insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs

PREFERRED OPTION: GIVE PRIORITY TO ENHANCING THE PROPORTIONALITY PRINCIPLE WITHIN TO SOLVENCY II AND MAKE A LOWER CHANGE TO THE EXCLUSION THRESHOLDS THAN WHAT IS PROPOSED BY EIOPA

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Compliance cost reductions by way of exclusion from Solvency II	According to EIOPA's impact assessment, by extending the threshold of exclusion from Solvency II, a maximum of 186 insurers would be excluded from Solvency II. This could represent a reduction in ongoing compliance cost of up to € 500 million	The recipients of this benefit are insurers. Considering that some Member States may decide to keep the current exclusion thresholds, the number of insurers which may be actually excluded could be lower than 186. Besides, some insurers may prefer to continue under Solvency II, notably in order to benefit from the passporting regime.
Compliance cost reductions by way of	The expected number of insurers concerned would be in the range between 249 and 435,	The recipients of this benefit are insurers. Additional firms could benefit from

enhancing proportionality for those insurers subject to Solvency II.	the latter in case the existing exclusion thresholds from Solvency II were not updated by Member States. For those insurers, automatic proportionate rules would apply, which could reduce ongoing compliance costs, up to EUR 50 million, according with the estimations of the Commission Services.	proportionality, but conditioned to approval by the supervisor (case by case analysis).
Indirect benefits		
Improved competition within the Single Market for insurance services.	The high cost of compliance is a barrier for new entries in the sector. By reducing the cost of compliance of the small and less risky insurers, it will be a reduction of the operating costs that will contribute to enhancing the profitability of the SME in the EU	Policyholders will benefit from a well-diversified offer of products coming from traditional firms and from new players.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Increase the thresholds of mandatory application of Solvency II	Direct costs			Compliance cost with national prudential rules, which in principle, should be lower than Solvency II, otherwise, the insurer can continue applying Solvency II	Ongoing compliance cost with national prudential rules.	Preparation of two supervisory teams in case a national regime was not implemented so far, and no insurer was under national regimes.	Ongoing training for supervisors to be knowledgeable about two different regimes.
	Indirect costs						
Enhance the proportionality within the framework	Direct costs			Submission by insurance companies of notification/ applications in order to benefit from proportionality measures.	Submission of regular reporting template to supervisors on the proportionality measures used.	Additional cost for supervisors when assessing the notifications of the low-risk profile insurers and approval process.	Ongoing monitoring of the proportionality measures applied by insurers.
	Indirect costs						

3.4. Problem 4: Deficiencies in the supervision of (cross-border) insurance companies and groups, and inadequate protection of policyholders against insurers' failures

PREFERRED OPTION: IMPROVE THE QUALITY OF SUPERVISION BY STRENGTHENING OR CLARIFYING RULES ON CERTAIN ASPECTS, IN PARTICULAR IN RELATION TO CROSS-BORDER AND TO GROUP SUPERVISION

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Enhance the protection of policyholders	The improvement of the clarity and robustness of the Solvency II framework based on the preferred option would improve the governance and financial robustness of insurance groups. Through the increase in quality in supervision it would also improve the ability of the supervisors to protect policyholders and beneficiaries both, in group and in cross border supervision. On the latter stronger coordination by EIOPA would ensure solutions in case of disagreement between authorities on complex cross-border cases and prevent possible insurer failures with negative effect on the policyholders and beneficiaries. Higher consistency of supervision would also contribute to a more harmonised level of policyholder protection.	Policyholders would be the main recipients of this benefit.
Enhanced risk sensitivity	The framework would better reflect all risks as it would lead to a clearer and more robust regulatory framework in terms of how to assess capital transferability or how entities from different financial sectors (e.g. banks) or countries (e.g. subsidiaries from third countries) should contribute to group risks.	Insurers and indirectly the policyholders would be the main recipients of this benefit.
More effective supervision	The framework will become clearer and more robust, existing gaps and uncertainties would be removed. Due to the stronger focus on cross-border supervision and cooperation between national authorities, the quality of the cross border supervision and the convergence of the supervision of insurance groups would be improved.	Insurers and indirectly the policyholders would be the recipients of this benefit.
International competitiveness	The preferred option (implying stricter rules governing the supervision of groups headquartered outside Europe) will improve the monitoring of third-country risk exposures for European entities, and more have more focus on capital and financial outflows from the European companies to the wider international part of the group. Reducing the risk of regulatory arbitrage could also have a positive impact on international competitiveness.	Insurers would be the main recipients of this benefit.
Improved ability to contribute to the long-term financing of the economy	Improved rules on group supervision would incentivise insurance groups to optimise their capital allocation and diversify their risks across the different entities of the group, with potentially positive impacts on the ability to provide funding in long term and sustainable assets across Europe.	Insurers would be the main recipients of this benefit.
Indirect benefits		
Positive contribution to financial	The increased risk sensitivity and of governance aspects through clarifying and strengthening the framework in group supervision would increase the resilience of insurance groups and thus the sector, which might lead to a	Recipients of this benefit are citizens and businesses at large

stability	greater resilience in stressed situations.	as well as national governments (less likelihood to involve taxpayer's money to address the consequences of a financial crisis).
Contribution to a more sustainable and resilient European economy	The preferred option will contribute to the functioning, and therefore the trust in the internal market and optimise the capital allocation of insurance groups. Further integration of the Single Market for insurance services stemming from this option can stimulate the cross-border supply of innovative insurance solutions, including those covering risks related to natural catastrophe, climate change. The improved rules on the group supervision would incentivise insurance groups to diversify their risks across the different entities of the group, with potential positive impact on the ability to provide funding in long term and sustainable assets across Europe.	Citizens and businesses would be the main recipients of this benefit.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Review of deficiencies in the supervision of (cross-border) insurance companies and groups	Direct costs			Higher compliance costs and increased capital requirements for some groups.	Higher compliance costs and increased capital requirements for some groups. Possible extra costs for insurance companies conducting cross border business.	Implementation costs for supervisors of strengthened and more intensive supervision of cross-border activities as well as for some groups.	Extra cost for the supervisory authorities in the Member states where insurers have significant cross-border activities. Intensified supervision of insurers' compliance with the strengthened and harmonised framework.
	Indirect costs		There is a risk that increased costs to business and administrations will be (partly) shifted to customers through increase				

			of insurance premium.				

PREFERRED OPTION: INTRODUCE MINIMUM HARMONISING RULES TO ENSURE THAT INSURANCE FAILURES CAN BE BETTER AVERTED OR MANAGED IN AN ORDERLY MANNER

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Reducing the likelihood of insurance failures	By clarifying the preventive powers and ensuring an adequate degree of preparedness, on both the industry and the supervisory sides, EU action would contribute to increasing the likelihood that an insurer in distress would effectively restore its financial position and continue to perform its functions for society.	Policyholders and beneficiaries, which includes the business sector in general, would be the main recipients of this benefit.
Improving policyholder protection	By reducing the likelihood of insurance failures and implementing a framework that would ensure that important insurance functions of a failing insurer continue to be performed, EU action would contribute to a better protection of policyholders.	Policyholders and beneficiaries would be the main recipients of this benefit.
Foster cross-border cooperation and coordination during crisis	A more coordinated decision-making between different public authorities and courts will contribute to reduce inefficiency costs and preserve the value of the failing entity.	Policyholders and beneficiaries would be the main recipients of this benefit. However, many insurers would also benefit from a more level-playing field in the measures taken by authorities to restore their financial conditions or resolve them.
Indirect benefits		
Preservation of financial stability, prevention of systemic risks, protection of the real economy and of public funds	EU action would ensure the continuity of functions by insurers whose disruption could harm financial stability and/or the real economy and to protect public funds (by limiting the risk of needing to "bail-out" failing insurers)	Society at large would be the recipient of this benefit, including taxpayers.
Better consideration of the interests of all affected parties	EU action would ensure that the interests of all affected Member States, including those where the parent company is located as well as those where the subsidiaries and branches of a failing group are located, are given due consideration and are balanced appropriately during the planning phase and when recovery and resolution measures are taken. It would therefore address potential risks of conflicts of interest for local supervisory and resolution authorities to give priority to the protection of "local"	Policyholders and beneficiaries would be the main recipients of this benefit.

	policyholders over other stakeholders	

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Implementing pre-emptive recovery planning	Direct costs			Insurance companies would have to develop pre-emptive recovery plans which might entail some staff, IT and consultant costs, unless they already are subject to such requirements on a local basis. An increased synergy with existing processes such as the ORSA could contribute to contain costs.	Insurance companies would have to periodically review, adapt and monitor their pre-emptive recovery plan as a part of their governance framework.	NSAs would have to set-up a framework for reviewing recovery plans. EIOPA estimated the costs to lie between 0.04 and 5 FTE depending on the situation of the concerned NSA.	NSAs would have to review and monitor recovery plans. EIOPA estimated the on-going costs related to these activities to range between 0.06 and 3 FTE.
	Indirect costs						
Implementing resolution planning, including resolvability assessments	Direct costs				Insurers would have to provide information that resolution authorities would require for the purpose of resolution planning.	Resolution authorities would have to set-up a dedicated insurance division that would draft resolution plans, including resolvability assessments. EIOPA estimated that the overall costs could range between 0.3 and 9 FTE and between EUR 21.000 and	Resolution authorities would have to maintain resolution plans and perform resolvability assessments. EIOPA estimated that the associated costs could range between 0.1 and 6 FTE and between

						EUR 450.000	EUR 21.000 and EUR 450.000.
	Indirect costs				In rare cases, insurers may be required to implement measures to address any identified impediments to resolution.		

PREFERRED OPTION: INTRODUCE MINIMUM HARMONISING RULES TO PROTECT POLICYHOLDERS IN THE EVENT OF AN INSURER'S FAILURE

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Improved policyholder protection	As presented in Annex 5, the default of insurance companies can expose policyholders to substantial social and financial hardship due to the discontinuation of their policies and the resulting absence of protection. These effects would be avoided by the implementation of an IGS. In addition, a minimum harmonisation of IGS design features across the EU would ensure a minimum level of protection throughout the Single Market, thereby ensuring a fair and equal treatment of all policyholders, whatever their place of residence.	Eligible claimants, i.e. policyholders and beneficiaries, which would be natural persons and micro enterprises, would be the major recipients of such direct benefits.
Protection of taxpayers' money	By transferring the burden of a failure back to the private sector, the need to use taxpayers' resources in the future in case of default of an insurance undertaking is reduced. Estimations of the benefits correspond to the degree of protection offered to policyholders under various assumptions. For further detail, please refer to Annex 5. A rough estimate would be that the introduction of an IGS would save around EUR 21 billion over 10 years of taxpayers' money.	Taxpayers would be the main recipients of such direct benefits. It should be noted however that EU action on IGS will affect taxpayers in Member States in different ways, depending on whether they are resident in a Member State already having an IGS or not.
Indirect benefits		
Improved supervision, in particular for cross-border activities	Following EIOPA's opinion, the implementation of a home country system for insurance guarantee schemes would incentivise supervisory authorities to ensure a better oversight of authorised entities, in particular when making use of their EU passport and performing cross-border activities.	Policyholders and beneficiaries would be the major recipients of such indirect benefits as EU insurance companies would be better supervised overall.

Improved competition in the insurance sector across the EU	The EU action would foster the level-playing field and competitiveness in the insurance industry across the EU. Competitive distortions between domestic and non-domestic insurers will be reduced, thereby contributing to a more efficient Single Market for insurance. The harmonisation of the geographical scope would also eliminate overlaps of existing IGSs as well as the associated costs.	The insurance industry would be the main recipient of these indirect benefits as they would be facing a more open and fair competitive environment. As a consequence, policyholders could also enjoy the effects of increased competition on their premiums and benefit from increased choice from the cross-border provision of services.
Better risk management practices and market discipline	Through an appropriate design (see Annex 5), EU action would create incentives for better risk management practices and would foster market discipline.	Policyholders and beneficiaries would be the main recipients of such benefits as insurance companies would have a reduced risk profile overall and consequently see a reduction in their probabilities of default. This element would also benefit insurance companies as this would foster competitiveness on sound grounds.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Introduce a minimum harmonised framework for IGS in all Member States	Direct costs		Assuming pre-funding, while the costs are primarily borne by insurance companies, a proportion of them will likely be passed on to policyholders. Therefore, a maximum estimate is that, during the build-up phase (assumed to be 10 years), the costs could be around EUR 2.33 for a yearly premium of EUR 1,000.		If we consider that the costs are not passed on to policyholders, the maximum cost estimate for the insurance industry could be around EUR 21 billion over a transition period of 10 years for example. This would represent a yearly capital cost of 0.12% of gross written premiums.	Member States where no IGS is in place would face set-up costs. For Member States where an IGS is already in place, the costs would depend on the elements of design and scope that would need to be adapted.	
	Indirect costs						

3.5. Problem 5: Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

PREFERRED OPTION: MAKE TARGETED AMENDMENTS TO PREVENT FINANCIAL STABILITY RISKS IN THE INSURANCE SECTOR

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Prevention of risks for the financial stability	Improvement of the ability of supervisors to prevent systemic risks stemming from or affecting the insurance sector	Recipients of this benefit are citizens and businesses at large as well as national governments (less likelihood to involve taxpayer's money to address the consequences of a financial crisis).
Better policyholder protection	The requirement for insurers to integrate macro-prudential considerations in their underwriting and investment activities would reduce incentives for excessive risk-taking behaviours.	Policyholders would be the main beneficiaries
Consistency with the risk-based nature of the framework	Supervisory intervention on dividends policies would be possible only when justified by the application of risk-based criteria.	Supervisors would continue to operate according to their legal mandates
Reduced liquidity risk which may not be appropriately captured under current rules	Improvement of the ability of supervisors to intervene in case of liquidity vulnerabilities not addressed by insurers	In Solvency II there is no quantitative requirement for liquidity risk as in the banking sector. Those additional tools would ensure that no standardised liquidity metric is specified in light of the variety of insurers' business models.
Indirect benefits		
Incentives for improved risk management by insurers, beyond capital requirements	Enhanced tools for insurers to assess own risks and their capacity to determine market-wide risks	Policyholders would be among the beneficiaries, but also insurers in the long run which would implement strengthened risk management system.
Minor impact on insurers' international competitiveness.	New requirements are in line with the international framework for systemic risk (e.g. no capital buffers to prevent the building up of possible future risks).	Measures would be applied to improve insurers' risk management systems while not implying tighter rules than their international competitors. Therefore, insurers would be the main recipients.

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Integration of macro-prudential considerations in insurers'	Direct costs			Costs for developing (or reinforcing) new underwriting or risk management systems	Costs for maintaining such new systems	Costs developing (or reinforcing) macro-prudential competences	Costs for maintaining such new competences and services

underwriting and investment activities						and services to assess macro-prudential risks in insurance	
	Indirect costs			Increased complexity in the risk management requirements for insurers			
Enhanced liquidity risk management by insurers	Direct costs			Costs for developing (or reinforcing) new liquidity risk management systems for insurers According to EIOPA, average one-off cost would be: 0.46 full-time equivalent (FTE) = 0.06% of total employees	Costs for maintaining such new systems According to EIOPA, average annual costs would be: 0.41 full-time equivalent (FTE) = 0.05% of total employees	Costs for developing (or reinforcing) supervision of liquidity management of insurers	Costs for maintaining such new competence
	Indirect costs						

ANNEX 4: PROPORTIONALITY AND SIMPLIFICATION MEASURES

	Full requirement	Simplified/proportionate requirement	Beneficiaries
Pillar 1	Valuation of life insurance obligations that include options and guarantees should by default use stochastic modelling	Valuation of life insurance obligations that include options and guarantees could use simpler deterministic approaches	Low risk profile undertakings meeting certain criteria
	All risks of the solvency capital requirements must be calculated at least annually	Immaterial risks may not be calculated annually	All undertakings which have immaterial risks
Pillar 2	There should be distinct persons in charge of key functions	The same person may cumulate several key functions in a firm	Low risk profile undertakings and, subject to approval, other insurers
	The own risk and solvency assessment (ORSA) should be conducted every year	The own risk and solvency assessment should be conducted every two years	Low risk profile undertakings and, subject to approval, other insurers
	A set of complex scenario testing should be used for the purpose of the ORSA	Simplified methods may be used in the own risk and solvency assessment	Low risk profile undertakings, and, subject to approval, other insurers
	Rules on deferrals of variable remuneration	No rules on deferrals of variable remuneration	Low risk profile undertakings subject to some criteria, and, subject to approval, other insurers
	Annual frequency of review of internal written policies	Triennial frequency of review of internal written policies	Low risk profile undertakings and, subject to approval, other insurers
Pillar 3	Frequency of regular supervisory report: at least, every three years	Triennial frequency of regular supervisory report	Low risk profile undertakings and, subject to approval, other insurers
	Annual frequency of publication of solvency and financial condition report	Triennial frequency of publication of "fully" solvency and financial condition report	Low risk profile undertakings and, subject to approval, other insurers
	Deadline for annual reporting: 14 weeks	Deadline for annual reporting: 16 weeks	All undertakings.
	Deadline for annual disclosure: 14 weeks	Deadline for annual reporting: 18 weeks	All undertakings.
	Regular supervisory report has to be drafted and submitted by each individual insurer	Single regular supervisory report for groups which could cover also the situation of the individual insurers in the scope of the group, and benefiting from less stringent deadlines.	Groups that meet some requirements
	Quarterly reporting of prudential information	Annual frequency of reporting of prudential information	Low risk profile undertakings and, subject to approval, other insurers

ANNEX 5: DISCUSSION ON THE TECHNICAL DESIGN OF THE MINIMUM HARMONISING RULES IN RELATION TO INSURANCE GUARANTEE SCHEMES (IGSS)

1. BACKGROUND

The present Annex complements the overall impact assessment on the Solvency II review by providing further insights on the options for introducing a harmonised minimum regime for Insurance Guarantee Schemes and their impacts. The analysis performed in this Annex does not address the issue of consumer guarantees related to the activity of occupational pension funds that are subject to a specific regulatory framework nor extend to reinsurance undertakings whose activities are more business-to-business and usually involve no retail consumers.

The methodology used to estimate the potential costs of establishing an IGS has been developed by the Commission's Joint Research Centre (JRC). This methodology as well as the detailed results of these estimations can be found in the technical report in Annex 6[114].

In the aftermath of the 2008 subprime crisis and the subsequent financial turmoil, the de Larosière Group recommended the setting-up of harmonised Insurance Guarantee Schemes (IGS) throughout the EU[115]. In response, the Commission announced in its Communication of 4 March 2009 "Driving European recovery" that it would review the adequacy of existing guarantee schemes in the insurance sector and make appropriate legislative proposals. In this context, the Commission published in 2010 a White Paper setting out a European approach to IGS including indications on appropriate follow-up measures (hereafter, the "2010 White Paper").

The European Parliament, in its resolution 2013/2658(RSP) adopted on 13 June 2013, called for further progress and concrete proposals for a coherent and consistent cross-border framework for IGS across Member States. The European Parliament based its request on the observation that some of these Member States experienced extreme difficulties when facing serious stress and on the need to complement the existing framework composed out of the Deposit Guarantee Schemes, the Investor Compensation Schemes and the Solvency II Directives. The European Parliament reiterated its call in the report on the Green Paper on Retail Financial Services in October 2016.

In 2018, the European Insurance and Occupational Pensions Authority (EIOPA) published a discussion paper on resolution funding and national insurance guarantee schemes, developing potential principles for harmonisation. In this context, EIOPA also conducted a survey about the existing regimes. On 11 February 2019, the Commission addressed a call for Advice to EIOPA on the review of Directive 2009/138/EC (Solvency II), including on IGSs. In July 2019, EIOPA issued a consultation paper on its Advice on the harmonisation of national insurance guarantee schemes across the Member States of the European Union, seeking feedback from stakeholders about this topic. The consultation closed in October 2019. The

[114] The lines of business considered in the context of these estimations, which are labelled as "life" and "non-life" insurance when presenting aggregated results in the context of this Annex on IGS, are disclosed in the technical report, section 2.2, table 1.

[115] "Recommendation 5: The Group considers that the Solvency 2 Directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes".
The full document is available by clicking here.

advice on IGSs[116] was included in the Solvency II Opinion that was published and submitted to the Commission on 17 December 2020.

2. INTRODUCTION

Based on the 2010 White Paper and EIOPA's Advice, an IGS is set to provide last-resort protection to policyholders when insurers are unable to fulfil their contractual commitments in case of failure. The aim is thus to protect natural or legal persons (i.e. policyholders and, where applicable, beneficiaries) from the risk that their claims will not be met if their insurance undertaking becomes insolvent. IGSs provide protection either by paying compensation to policyholders (or beneficiaries) for their claims, or by securing the continuation of their insurance contract. This can be done either by facilitating the transfer of the policies to a solvent insurer or by directly administrating the policies as a bridge institution.

2.1. A fragmented landscape

Unlike the banking and securities sectors, there are no harmonised EU rules for IGSs for the time being. When they have an IGS, Member States have each chosen their own approach in terms of IGS design: geographical coverage (where does the IGS protection extend?), purpose (does the IGS act as a "pay box" or can it take other actions?), scope of eligible policies (what is subject to IGS protection?), coverage level (what amount are policyholders actually protected for?), eligible claimants (are all policyholders protected or only natural persons?) and funding (does the IGS have sufficient financial resources to act?). These approaches can diverge quite substantially from each other, thereby affecting the treatment of policyholders in the event of failure, in particular in a cross-border case.

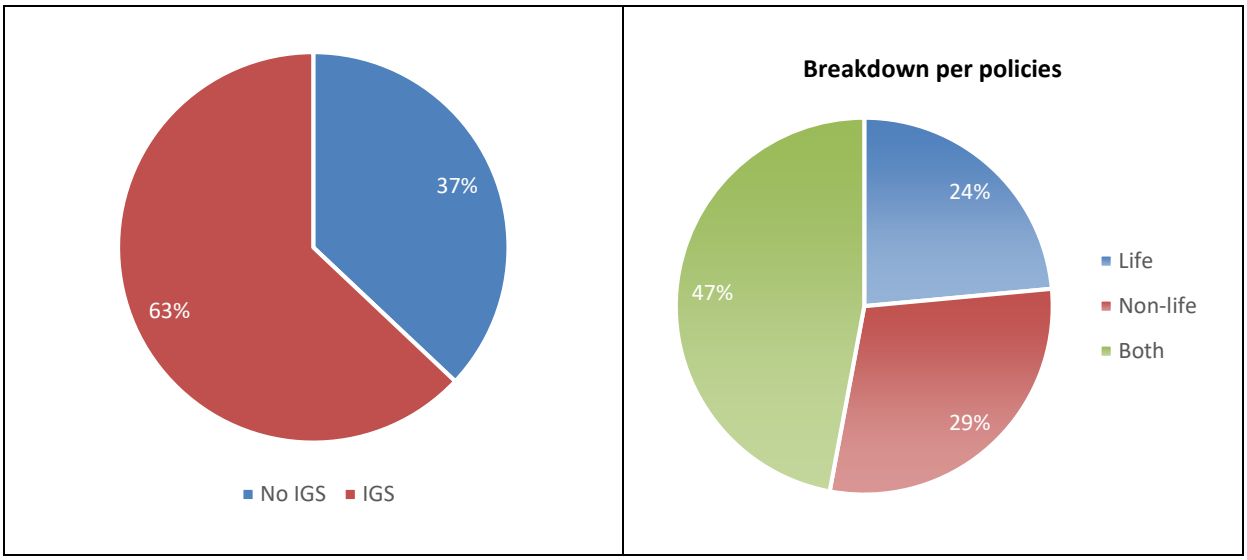
As shown by EIOPA[117] and summarised in table 1, 17 Member States (and Norway) operate one or more IGS(s). Of those, eight[118] Member States (and Norway) cover both life and (selected) non-life policies insurance; five[119] Member States cover (selected) non-life insurance only; and another four[120] Member States cover life insurance policies only.

Table 1 – Existing policyholders' protection schemes in the EU 27

Source: EIOPA

Excluding Motor Liability Insurance policies, 17 Member States (AT, BE, BG, DK, EE, FI, FR, DE, EL, IE, IT, LV, MT, PL, PT, RO, ES) have already implemented one or more IGS, covering some life and/or non-life policies. 10 Member States (HR, CY, CZ, HU, LT, LU, NL, SK, SE, SI) have not implemented any IGS.

[116] Together with an advice on a minimum harmonisation of the recovery and resolution framework.
[117] See Annex 13.1 of the background analysis supporting EIOPA's Advice.
[118] Austria, Belgium, France, Latvia, Malta, Poland, Romania, and Spain.
[119] Denmark, Finland, Ireland, Italy and Portugal.
[120] Bulgaria, Estonia, Germany and Greece.



This situation means that, under the current conditions, not all policyholders in Europe benefit from the protection of an IGS and that, where they do, policyholders with similar policies would not necessarily enjoy the same degree of protection in the event of liquidation.

In addition, the continued increase of cross-border activity in insurance – providing insurance services in other countries either directly (free provision of services or FoS) or by setting up branches (freedom of establishment or FoE) – emphasises the importance of a harmonised approach to consumer protection. At year-end 2018, in the EEA, EUR 82.5 billion gross written premiums (GWP) are reported via free provision of services (FoS) and EUR 71.7 billion via freedom of establishment (FoE)[121]. The previous period, EUR 66.5 billion GWP were reported via FoS and EUR 75.5 billion via FoE. This accounted for approximately 10% of all gross written premiums in the EEA at the end of 2017, which is an increase of 25% compared to 2016 when the cross-border business accounted for 8% of GWP in the EEA. Out of 2686 (re)insurers under Solvency II, 847 reported cross-border business within the EEA in 2017 compared to 750 in 2016[122]. Even in Member States that have IGSs, these schemes do not necessarily always cover cross-border activities.

History shows that the decision to establish an IGS in the Member States, and most probably its structure, have been prompted by a concrete (risk of) insurance failure. Where no major defaults took place to date there was not much incentive to set up an IGS. EIOPA provides in its background analysis the following list of examples.

- In the early 1920s, the Austrian system was introduced and significantly improved after the failure of an insurance company;
- The Spanish system founded in 1984 answered the need for protection of policyholders as a consequence of the market reorganisation linked to Spain's accession to the EU;
- The French life and health fund was created in 1999 following a near failure experience of a life insurer;
- In Germany, the creation of the health scheme was an initiative of the health insurance sector that aimed at strengthening the trust in the sector following financial stress in 2002. While no failure were observed so far (neither in the health sector nor in the life insurance market) an IGS for life insurance was also introduced;
- In Greece, the scheme was established shortly after the failure of two large life insurers in 2009.

[121] See p 633 of the background analysis supporting EIOPA's Advice.
[122] See pp 684-685 of the background analysis supporting EIOPA's Advice.

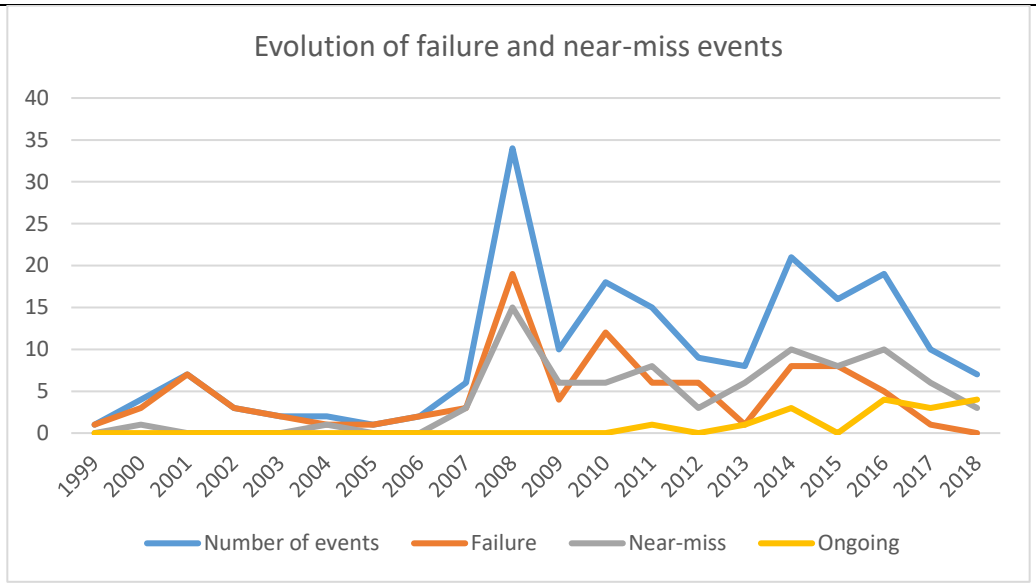
2.2. The failure of insurance companies

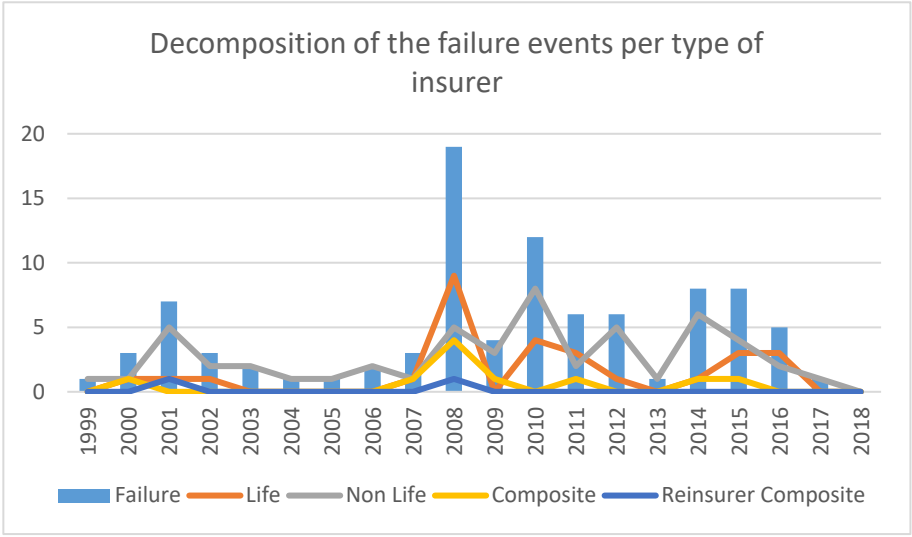
In 2014, EIOPA started to gather information from NSAs on a voluntary basis about relevant cases of insurance failures and near misses that occurred in the European Economic Area. It comprises now a sample of 195 affected insurance undertakings from 1999 to 2018. As illustrated in table 2 below, failure and near-miss incidents have been decreasing since the subprime crisis (2008) and the entry into force of Solvency II (2016) further contributed to that trend.

Table 2 - Cases of failure and near-miss reported to EIOPA

Source: EIOPA own database of failure and near-misses events, European Commission

The evolution of reported failure and near-miss events spiked during the subprime crisis and the following sovereign crisis. The overall trend is however decreasing, in particular since the entry into force of Solvency II. With the material exception of the subprime crises, most failure events concerned non-life insurers. From 2016 onwards, non-life insurers represented 55.6% of the cases while life insurers and composite insurers represented 30.6% and 13.8% of the cases respectively. The analysis of the causes of failure (see below) confirms that life insurers are particularly affected by adverse market developments. This is reflected in the graphs.





On 25 February 2020, KPMG published a review of insurance companies' insolvencies and business transfers in Europe[123] that concluded on the positive effects of prudential regulations introduced in Europe since 2001. In particular, the study noted that failures after 2001 have significantly reduced in numbers and concerned smaller companies, thereby creating less impact and affecting fewer creditors.

However, the past financial crisis (2008) required governments to intervene in the financial sector, including in the insurance business, in order to minimise losses to consumers and/or maintain financial stability[124]. EIOPA considers in its background analysis (see § 13.60) that the Solvency II framework has significantly improved the supervision of insurers and, therefore, contributed to the reduction of the likelihood of insurance failures but has not fully eliminated this risk. It should indeed be acknowledged that capital requirements are not designed to cover all unexpected losses.

Such situation has been illustrated by recent cross-border failures that left unsuspecting policyholders without coverage and exposed the absence of cross-border coordination mechanisms, with sometimes disagreements and media coverage as to which Member State is responsible for compensation of policyholders or beneficiaries (See box below for some examples).

Examples of cross-border failures

Company A

Company A was incorporated in an EEA country without IGS protection. It wrote various types of insurance across the EU market using its EU passport, but not in its country of incorporation. In 2016, its failure left 120,000 policyholder in eight Member States, including Denmark, uncovered. Among others, the Danish Parliament decided to extend the coverage of the Danish IGS to Danish policyholders that had an outstanding insurance claim against the company. Subsequently, Denmark decided that its IGS should permanently switch from the home country principle to the host country principle, as of 2019.

[123] This study – prepared for, an on behalf of, the following industry associations: ICISA, ITFA, IUA and Lloyd's Market Association – reviewed the non-life insurance company failures over the last 30 years within UK, FR, IT, DE, NL, SE and Gibraltar.

[124] See European Commission, State Aid Scoreboards and European Commission, "Note for discussion by Expert Group on Banking, Payments and Insurance (EGBPI) meeting on 5 March 2015".

Company B

Company B was an EU-based insurance group that had approximately 400,000 policyholders in ten Member States. It mainly provided insurance policies on motor, property, general liability and income protection insurance. It was declared bankrupt in 2018, just before its home country changed the coverage of its IGS from the Home country principle to the Host country principle. A later declaration would have meant that the policyholders residing outside of its home country would have no longer been protected by the local Guarantee Fund. For example, it had 51,000 policyholders in another Member State, with around 1,500 outstanding claims at the date of failure.

'*Dommage ouvrage*' insurance in France

Several EU-based companies offering, among others, builders warranty insurance in France through their EU-passport went into bankruptcy in the last five years. This specific product was either not covered or not eligible for protection from the local IGS. Given that the French IGS applied a home-country principle at that time, the French policyholders of these failed companies suffered substantial losses and/or long delays until they were compensated from the insolvency estates.

Insurance companies, like any other commercial companies, can still fail and produce substantial losses; and, when it occurs, not all claims can necessarily be covered from the insolvency estate of the failed undertaking. EIOPA stresses that these recent failures of cross-border insurers have proven that even in a Solvency II environment, failures of insurers cannot be avoided. EIOPA further concludes that the risk of policyholders being exposed to potential financial loss and/or social hardship remains real. Another example is the case of a Dutch life insurance company that was declared bankrupt at the end of 2020. Based on a preliminary valuation performed by the curator, the entitlement of policyholders could have to be restricted to 70% of their claims.

Beyond the non-zero likelihood of failures (see also next section), an analysis of their main causes provide further insights, especially in the current economic context. Such an analysis was already provided in the 2010 White Paper, in reference to the 2007 Oxera report[125]. These causes appeared to be sometimes linked, sometimes not linked, to financial markets and depended on the nature of the insurance activities.

Non-life insurance undertakings, for instance, are usually less affected by financial market developments due to the short duration of their policies and of the corresponding investment portfolio. Their losses tend to arise mainly from non-financial liabilities and the realisation of related underwriting risks. In fact, losses by non-life insurers are typically caused by higher than expected claims (due, for example, to natural catastrophes, etc.) or mispricing (i.e. premiums do not adequately reflect the insured risks) rather than by investment losses.

By contrast, considering the long duration of their asset-liability structure, life insurers are much more exposed to financial market developments and their losses are usually mainly generated by financial liabilities. This does not mean however that life insurers could not be exposed to insurance losses from non-financial events, such as unexpected rates of mortality due, for example to pandemics or increased longevity. However, market and investment risks appear to be the main sources of risks for them. This is particularly the case for ancillary insurance portfolios for which life insurers offered a guaranteed investment performance to policyholders. In terms of mechanics, when financial markets fall or in period of high market volatilities, returns on assets could be significantly reduced while simultaneously the

[125] For an in-depth complementary analysis of the risks faced by insurance undertakings, please see subsection 4.1 of the 2007 Oxera report.

actualised value of liabilities could be increased (as notably the discount rate decreases), making life insurers particularly sensitive to losses arising from their financial positions.[126]

These observations have been confirmed by the empirical evidences provided by EIOPA in its 2018 report on (near-)failure cases, based on data spanning from 1999 to 2016. In addition, in the four latest publications of its Financial Stability Reports, EIOPA stressed the sensitivity of insurance undertakings to market developments and, in particular, the effects of protracted low interest rates. This situation, confirmed by the International Monetary Fund (IMF) in its April 2020 Global Financial Stability Report, has been identified as a key risk for both insurers and pension funds, putting pressure on both their capital positions and their long-term profitability. In its 2021 outlook for the European Insurance Sector, published on 10 December 2020, Moody's Investors Service warned about the negative impacts of low interest rates and of the prostrated prospects for the overall economy, affecting both life and non-life insurers' revenues and profit margins.

EIOPA noted the following other vulnerabilities stemming from the current economic environment:

- Large declines in interest rates could create further incentives for insurers and pension funds to search for yield and undergo riskier investments.
- Maturing fixed-income securities could only be replaced by lower yielding securities (i.e. so-called reinvestment risk), gradually affecting profitability, in particular for insurers and pension funds with relatively high nominally guaranteed liabilities and large exposures to fixed-income securities.
- In case of sudden increase of interest rates, life insurers could also suffer a sudden increase in lapses and surrenders, as other financial investments may become more attractive for instance. Life insurers could then face an increase in both lapses and surrenders in a short period[127], leading to possible liquidity constraints.

Apart from operational causes, the 2010 White Paper also considered that losses for insurance undertakings might be generated by fraud and, more generally, by the severe agency problems that insurance undertakings are potentially subject to. These agency problems, mainly caused by the length and the "inversion" feature of the insurance cycle, i.e. the fact that premiums are cashed in at an early stage and that claims are paid off only at a much later stage, could induce risk-taking behaviours and wealth-shifting from policyholders to shareholders for instance.

Furthermore, in its December 2019 Financial Stability Report, EIOPA considered that the level of interconnectedness with banks and a high degree of home bias in investments could lead to potential spillovers of risks from other sectors and increase the sovereign-insurance loop. This situation was also highlighted by the IMF in its April 2019 Global Financial

[126] As noted in the 2010 White Paper, when life insurance contracts are non-unit linked, investment/market risk is normally borne by the insurance undertaking. On the contrary, when life insurance contracts are unit-linked, investment/market risk is normally borne by policyholders. On the basis of EIOPA's Financial Stability Report of July 2020, it appears that the share of unit-linked business, while having slightly increased in the first quarters of 2019, remains lower that the levels in 2017 and 2018 with an average share at the end of 2019 of 36,5%. In reality, however, distinctions are difficult as in both unit-linked and non-unit linked products investment risk is shared de facto between insurers and policyholders. In the unit-linked sector, in fact, there are many insurance undertakings that offer guarantees to policyholders. They take a wide variety of forms including minimum returns, fixed annuity rates as well as contractual terms such as early or regular withdrawal of funds on terms that give policyholders valuable options. Thus, in these cases, the insurance undertaking bears some of the market/investment risk and clear-cut distinctions are difficult to draw.

[127] Although several legal implications, such as penalties or fiscal benefits, could limit the impact of lapses and surrenders in some countries, EIOPA notes that this situation could add additional strains on insurers' financial position once yields will start increasing.

Stability Report where it stressed that insurance companies could also become entangled in the sovereign-financial sector nexus given their significant holdings of sovereign, bank and corporate bonds. In particular, the IMF stressed that insurance companies in some countries have a high share of riskier securities (subordinated and hybrid debt) in their bank bond holding, thereby being more exposed to shocks and possible write-down of debt instruments in the banking sector.

2.3. The default likelihood of insurers

An empirical analysis of failures and near-misses reported voluntarily by NSAs in EIOPA's internal database since the entry into force of Solvency II (2016) shows that there has been a small but non-negligible number of failures or near-failures that involved mainly small non-life insurers, some of which with a cross-border dimension.

Out of the 36 cases that composed the sample, six cases concerned companies with total assets above EUR 1,000 Million. Most of them represented a small share of the market (all reported cases, except two, had a market share of below 10% for their non-life or life business). 27.8% involved a cross-border dimension as the failing insurers were active abroad through of one or more branches (cases of direct cross-border selling may be under-reported). The (near-)failing insurer was part of a group in one third of the cases (33.3%). 25% of the cases in the sample were on-going in 2020.

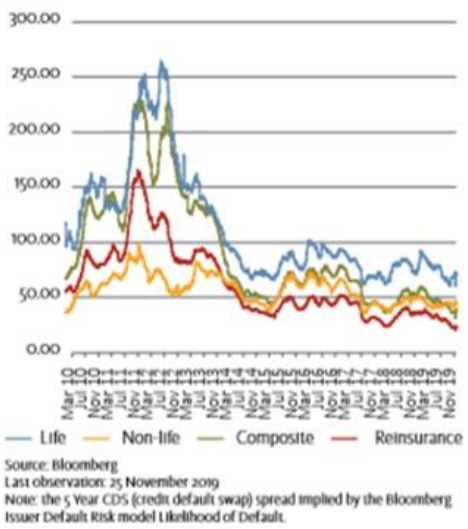
By contrast, the market perception seems to focus on the economic environment and prevailing market conditions, considering that life insurers are generally more risky than non-life insurers. Please refer to table 3 below showing the evolution of the insurance credit default swap (CDS) spreads from March 2010 to November 2019 (from EIOPA June 2019 Financial Stability Report, left panel) and from January 2008 to March 2021 (right panel).

Table 3 – Default risk perception of the insurance sector based on CDS spreads

Sources: Bloomberg, EIOPA June 2019 Financial stability report (left panel), EIOPA (right panel)

The price of a CDS (i.e. its spread) reflects the perceived credit quality of the referenced underlying asset. It therefore echoes the default risk perception of the market. The evolution and level of CDS spreads show a higher default perception for life insurers, and a greater sensitivity to market conditions. That observation might reflect the current challenges faced by life insurers in an environment of prolonged low interest rates and economic slowdown. The perception of default is however generally lower nowadays than during the subprime and sovereign crises. The default perception for non-life insurers moves around the one of composite insurers or reinsurers. It appears to be regularly above these ones since the end of 2013, and in particular at the end of 2019 and at the beginning of 2021.

Figure 1.14: Insurance CDS spreads



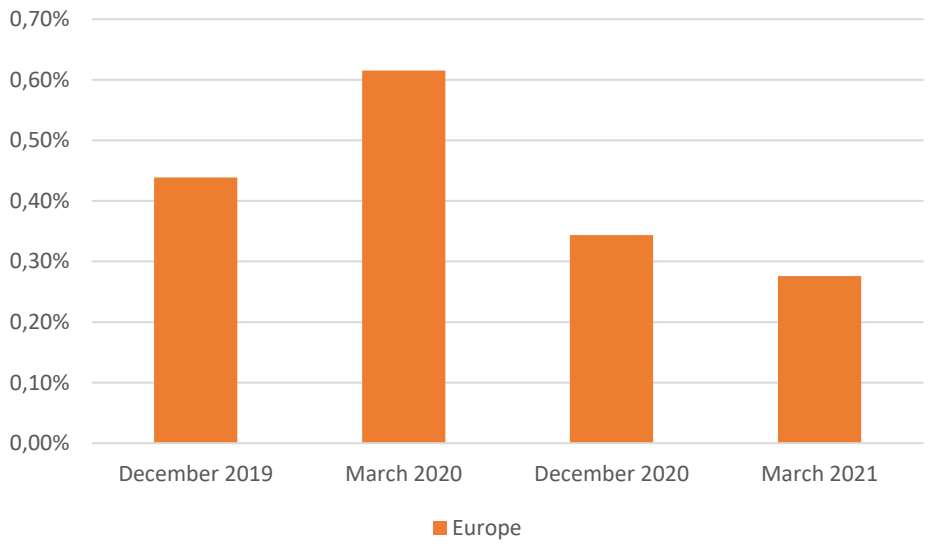
Source: Bloomberg
Last observation: 25 November 2019
Note: the 5 Year CDS (credit default swap) spread implied by the Bloomberg Issuer Default Risk model Likelihood of Default.

Other indicators of the likelihood of failures are available. Table 4 below presents the evolution of the one-year default rate forecast developed by Moody's Investors Service from December 2019 to March 2021.

Table 4 – One-year default rate forecasts for EU insurers

Sources: Moody's Investor Service, European Commission

The forecasts developed by Moody's are issuer-weighted and include both investment-grade and speculative-grade companies. After a peak in March 2020, we observe a decreasing trend towards a default rate of 0.20%.



Moody's sets the default rate (over a one-year horizon) as per March 2021 to 0.28% for EU insurers. Caporale et al. estimate the probability of default of all firms in the last ten years

lays between 0.2% and 0.4%.[128] A more recent publication from A.M. Best Company publishes estimate for the liquidation rates in the US insurance sector to be around 0.36%.[129]

Therefore, on the basis of both historical data and model estimations, and for the purposes of this impact assessment, it has been decided to test three possible values for the "average over the cycle" probability of default (PD) of insurance undertakings: 0.05%, 0.1% and 0.5%. The higher rate of 0.5% corresponds to the Solvency II "target". The lower rate of 0.05% is considered to envisage the possibility that estimates based on the conventional insolvency definition might be an over-estimation of the occurrence of failures in practice.

2.4. Estimates of potential losses associated with the failures of insurance companies

Failures of insurers can lead to substantial losses. However, considering probabilities of default of 0.05%, 0.1% and 0.5%, not all insurers are expected to default and not all at the same time. Historical cases mentioned above provide only a very general and rough indication of losses that might affect policyholders in the future. It can however be reasonably expected from these past examples that estimated potential losses would, in general, be lower than those potentially triggered by the failure of the largest insurer in each domestic market.

For the purpose of the impact assessment, the Commission services estimate the losses affecting policyholders using a theoretical model that is consistent with the one used for the 2010 White Paper. As explained in the 2010 White Paper, the order of magnitude of the estimated loss distributions are tested based on selected past failures in the EU that fall in a range between the 75% and the 99% percentile of the estimated loss distributions.

The technical report (see Annex 6) explains in detail the Credit Value-at-Risk (Vasicek-model[130]) methodology and the estimated losses potentially affecting policyholders in each Member State in a one-year time horizon.

The model in question allows to estimate policyholders' losses combining the effect of various elements, such as:

- the exposure at default (EAD);
- the probability of default (PD);
- the correlation of defaults between insurers (how probable is it that defaults happen at the same time);
- the concentration of the insurance market (how many insurers dominate the market); and,
- the severity (Loss Given Default) of the losses in case of default.

Table 5 presents the EAD of the whole insurance sector in each Member States and in the EU at the end of 2018. The EAD is an estimation, based on technical provisions and solvency capital requirements, of the maximum losses for the society that would occur in each Member State and in the EU in the case of failure of the entire insurance sector[131]. These hypothetical

[128] G. M. Caporale, M. Cerrato, X. Zhang, Analysing the determinants of insolvency risk for general insurance firms in the UK, Journal of Banking and Finance 84, 2017.
[129] Best's Impairment Rate and Rating Transition Study – 1977 to 2018 - Impairment Review, June 12, 2019, The Best Company.
[130] The main reason supporting the choice of a Vasicek model has been the limited amount of information available to feed in the model. A Vasicek model is also used, for example, in the derivation of FIRB capital requirements under Basel II. For more details on the Vasicek model, see Section 2.1 of the technical report.
[131] On the methodology used to estimate the EAD, see in the technical report, Section 3.5.

maximum losses illustrate the systemic relevance of the entire sector for the economy and potential exposure for policyholders or taxpayers, in the absence of IGS.

Table 5 – Exposure at default (EAD) in EEA and EU countries, 2018[132]

Source: Joint Research Centre, European Commission

The figures presented below illustrate the maximum possible loss estimated on the basis of the **continuation principle** that delivers a slightly higher amount than under the assumption of a compensation principle. Reported figures are in million EUR.

	Total	Life	Non-life			Total	Life	Non-Life
AT	95.050	82,655	13,538		**IT**	783,723	716,209	65,906
BE	264,963	248,278	22,617		**LI**	23,720	20,563	3,576
BG	1,811	627	1,181		**LT**	1,043	813	282
CY	2,572	1,940	668		**LU**	191,086	175,111	20,536
CZ	11,083	7,381	3,915		**LV**	590	257	334
DE	1,551,858	1,358,998	221,471		**MT**	4,896	4,548	1,025
DK	326,265	312,802	13,587		**NL**	422,767	376,222	50,673
EE	1,506	1,091	464		**NO**	159,726	147,318	14,159
EL	13,104	10,743	2,306		**PL**	27,623	19,360	8,325
ES	231,999	201,108	34,296		**PT**	47,537	44,422	3,246
FI	63,728	58,518	5,781		**RO**	2,463	1,394	1,063
FR	2,226,836	2,025,166	215,131		**SE**	240,010	210,829	31,106
HR	3,792	2,811	1,003		**SI**	5,935	4,032	2,220
HU	6,894	5,721	1,231		**SK**	4,882	4,048	894
IE	250,803	223,342	31,966		**EU 27**	**6,784,822**	**6,098,429**	**754,766**
IS	675	111	562		**EU-EEA**	**6,968,944**	**6,266,422**	**773,062**

Table 6 presents the EAD/GDP ratios at the end of 2018. For the entire EU 27, the EAD of the insurance sector at the end of 2018 would amount to about 50% of the GDP.

Table 6 – Exposure at default (EAD) over GDP in EEA and EU countries, 2018

Source: Technical report, Eurostat

The figures presented below are ratios of EAD over GDP on the basis estimated maximum losses

[132] As stated in the technical report, due to the difference in Gross Direct Written Premium (GDWP)/Technical Provision (TP) ratio, and possibly in similar TP/Solvency Capital Requirement (SCR) and GDWP/SCR ratios, approximations to obtain estimates of EAD without motor and import of services from outside the EU introduce uncertainty in the calculations. This could result in some counter-intuitive results, such as seeing Total insurance not corresponding to the actual total of "total life" and "total non-life". A statistical procedure to force reconciliation could have been used to minimize these discrepancies. This would however have required the introduction of further assumptions and could increase the possible error in the final estimates. It was therefore chosen not to force reconciliation.

presented in table 6 of the technical report.								
	Total	**Life**	**Non-life**			**Total**	**Life**	**Non-Life**
AT	25%	21%	4%		**IT**	44%	40%	4%
BE	58%	54%	5%		**LI**	407%	353%	61%
BG	3%	1%	2%		**LT**	2%	2%	1%
CY	12%	9%	3%		**LU**	318%	292%	34%
CZ	5%	3%	2%		**LV**	2%	1%	1%
DE	46%	40%	7%		**MT**	39%	36%	8%
DK	108%	103%	4%		**NL**	55%	49%	7%
EE	6%	4%	2%		**NO**	43%	40%	4%
EL	7%	6%	1%		**PL**	6%	4%	2%
ES	19%	17%	3%		**PT**	23%	22%	2%
FI	27%	25%	2%		**RO**	1%	1%	1%
FR	94%	86%	9%		**SE**	51%	45%	7%
HR	7%	5%	2%		**SI**	13%	9%	5%
HU	5%	4%	1%		**SK**	5%	5%	1%
IE	77%	68%	10%		**EU 27**	**50%**	**45%**	**6%**
IS	3%	1%	3%		**EU-EEA**	**50%**	**45%**	**6%**

As stressed by EIOPA through the notion of "financial and social hardship" developed in its Advice, losses incurred by policyholders might be different in nature depending on the insurance contract and on how the failure is resolved. Failure of a life insurer may cause the loss of expected policy benefits, which can be significant particularly if the policy was purchased to provide for retirement income. Losses on savings and investment products may equally result in important wealth losses, when guarantees given cannot be honoured. With regard to non-life insurance failures, losses to policyholders may result from the loss of the policy benefit (e.g. protection), in particular regarding the open claims, as well as from the loss of premiums already paid in advance.

Assuming a probability of default of 0.1%, and in total absence of IGS in Member States, losses resulting from failures of insurance undertakings happening in a one-year time horizon, that could (with a 99th confidence level) be passed on to policyholders or taxpayers, could amount to[133]:

- 13.6 billion EUR for total (life and non-life) insurance in the whole EU, which is some 1.50% of the total EU annual gross written premiums;
- 12.3 billion EUR for life insurance only, which is some 2.12% of the EU annual gross written life premiums;
- 1.5 billion EUR for non-life insurance only, which is some 0.46% of the EU annual gross written non-life premiums.

These estimations show that, when EU insurance undertakings fail, EU policyholders or taxpayers could incur very significant losses. The current fragmented landscape of national

[133] Results displayed may be slightly overstated, as the single factor model that is used assumes the same correlation factor between insurance undertakings across all Member States. Results are provided for the year 2018 under the home and continuation principles, a probability of default of 0.1% and a confidence level of 99%. Similar results are observable for 2016 and 2017.

IGSs raises significant questions as to their ability to mitigate adequately the potential losses for policyholders and beneficiaries.

Based on the information provided in table 1, around 37% of the losses resulting from failures of insurance undertakings would not be covered by any IGS, which would amount approximately to 5 billion EUR for total (life and non-life) insurance in the whole EU. The remaining 63% would only be partially covered, as not all existing IGS ensure full coverage of all life and non-life policies. On the basis of a rough estimates of the coverage level, approximately 53% of these policies would appear not be covered, leading to an additional uncovered loss of 4.5 billion EUR.

At this juncture and despite funds available in existing IGS, significant losses stemming from the failure of insurance undertakings could reach about 9.5 billion EUR and affect EU policyholders or taxpayers.

In view of the increasing importance of cross-border activities, the divergent geographical approaches across the EU could be a concern for the appropriate coverage of those activities by existing IGSs.

Based on the model estimations, assuming a probability of default of 0.1%, losses that could (with a 99th confidence level) result from exported/imported cross-border business and hit non-domestic/domestic policyholders or non-domestic/domestic taxpayers in a one-year time horizon, could amount to[134]:

- EUR 0.99 billion for total insurance, which is around 1.50% of total (life and non-life) annual gross written premiums paid in the EU for cross-border insurance;
- EUR 0.90 billion for life insurance, which is around 2.12% of life annual gross written premiums paid in the EU for cross-border insurance;
- EUR 0.11 billion for non-life insurance, which is around 0.46% of non-life annual gross written premiums paid in the EU for cross-border insurance.

It follows from this empirical analysis that significant losses stemming from defaults of insurance undertakings operating in a cross-border setting could be exported to non-domestic policyholders. Similarly, domestic policyholders could suffer important losses if they have purchased policies from a defaulting insurance undertaking in another Member State, when these losses are not covered by an IGS in the Home and/or the Host Member State.

Losses could (partially) be recovered from the estate of the liquidated insurer. However, this process takes time and is cumbersome. An IGS could subrogate into the policyholders' claims and recover more efficiently from the estate than natural persons and small companies could do. Therefore, IGS have the potential to cover the gap in terms of timing and in terms of remaining losses. The recoupment from the insolvency estate could contribute to the replenishment of any pre-funded IGS.

2.5. Objectives of an EU action

Taking into account the domestic and cross-border context, potential future EU action on IGS protection should pursue the main objective of ensuring an even and comprehensive protection of policyholders. Achieving this objective would contribute to maintaining consumers' confidence in the insurance sector and the Single Market for insurance. By protecting policyholders' wealth and avoiding suboptimal allocation of insurance failure losses to taxpayers, the framework would prevent or mitigate possible consequential

[134] Figures are based on a probability of default of 0.1% and calculated at year-end 2018.

slowdowns of the real economy and preserve more generally the system-wide stability of financial markets.

In this perspective, the design of the IGS framework and the analysis of policy options will consider the following elements as additional objectives.

1. Avoid competition distortion: the design of the IGS framework should contribute to a level-playing field between insurance companies and ensure competitive neutrality for business conducted by domestic insurers and incoming EU insurers that operates through FoS or FoE.

2. Reduce moral hazard: the design of the protection mechanisms should take account of the risk of moral hazard for policyholders, insurers and supervisors/public authorities. As pointed out by EIOPA[135], the existence of a safety net in the form of an IGS could lead consumers to be less inclined to do a proper due diligence. However, this assumes that consumers are generally well informed. Given the difficulty for consumers to assess risk-related information, it can be argued that the introduction of a protection mechanism would not induce wrong incentives. Similarly, a harmonised framework on IGS should prevent taxpayers from ultimately bearing the costs of an undertaking's mismanagement by introducing a legal framework which is financed by the undertakings themselves and that does not incentivise excessive risk-taking[136]. Finally, the design of an IGS should ensure that supervisors are encouraged to carry out their supervision properly, including in the context of cross-border activities[137], facing the financial consequences of resorting to the last resort safety net.

3. Ensure cost efficiency: As explained in the 2010 White Paper, EU action on IGS should strike the right balance between the benefits to policyholders and the costs linked to the protection offered. This means that both welfare costs of protection as setup costs would need to be minimised taking into account existing national structures. In the end, an IGS that is not cost efficient would lead to higher costs for policyholders. This approach takes account of the costs redistribution effect provided through the implementation of the IGS, noting that it would absorb an amount of losses that is equal to the losses that would hit consumers (or taxpayers) in the absence of such a protection mechanism.

4. Ensure market confidence and stability: EU action on IGS should finally aim at enhancing market confidence and furthering the stability of the EU internal market in insurance services.

3. ANALYSIS OF POLICY OPTIONS

This section builds extensively on EIOPA's Advice that duly analysed the costs and benefits of the main options considered from a qualitative point of view. Where relevant (and feasible considering the data limitations), EIOPA's analysis and conclusions are completed by quantitative estimations provided by the model developed by the Commission services.

[135] See § 13.37 of EIOPA's background analysis.
[136] See § 13.38 (and footnote 342) of EIOPA's background analysis.
[137] A resolution authority or an administrator may focus on the interests of creditors and policyholders in their own jurisdiction, e.g. by ring-fencing the capital instead of using it to cover capital shortages in other Member States. Supervisors have reduced incentives to supervise insurers that concentrate on FoE and FoS.

The following table adapts table 13.1 of EIOPA's background analysis and provides an overview of the main options that have been considered. Options indicated in bold are those advised or preferred by EIOPA.

Policy Issues	Options
1. Need for harmonisation of national IGSs in the EU	1.1 No change (maintain status quo) 1.2 **European network of national IGSs (minimum harmonisation)** 1.3 Single EU-wide IGS (maximum harmonisation)
2. Need for harmonisation of roles and functions of national IGSs	2.1 Full discretion to Member States 2.2 Compensation of claims 2.3 Continuation of policies 2.4 **Continuation of policies and/or compensation of claims**
3. Need for harmonisation of geographical scope of national IGSs	3.1 Full discretion to Member States 3.2 **Home-country principle** 3.3 Host-country principle 3.4 Host-country principle plus recourse arrangements
4. Need for harmonisation of eligible policies	4.1 Full discretion to Member States 4.2 Life policies only 4.3 Non-life policies only 4.4 Both life and non-life policies 4.5 **Selected life and non-life policies**
5. Need for harmonisation of the coverage level	5.1 Full discretion to Member States 5.2 Determine a single minimum ceiling (e.g. EUR 100,000) across Member States 5.3 **Determine a minimum ceiling and a percentage share for life, and only a percentage share for non-life insurance**.
6. Need for harmonisation of the timing of funding	6.1 Full discretion to Member States 6.2 Ex-ante funding 6.3 Ex-post funding 6.4 **Ex-ante funding complemented with ex-post funding**
7. Need for harmonisation of the nature of contributions	7.1 Full discretion to Member States 7.2 Flat-rate contributions 7.3 **Risk-based contributions**
8. Need for harmonisation of the target level	8.1 Full discretion to Member States 8.2 **Harmonization at EU level** 8.2.1 Low risk, low security (PD=0.05%, percentile=75%) 8.2.2 Low risk, medium security (PD=0.05%, percentile=90%) 8.2.3 Low risk, high security (PD=0.05%, percentile=99%) 8.2.4 Medium risk, low security (PD=0.1%, percentile=75%) 8.2.5 Medium risk, medium security (PD=0.1%, percentile=90%) 8.2.6 **Medium risk, high security (PD=0.1%, percentile=99%)**

	8.2.7 High risk, low security (PD=0.5%, percentile=75%) 8.2.8 High risk, medium security (PD=0.5%, percentile=90%) 8.2.9 High risk, high security (PD=0.5%, percentile=99%)
9. Need for harmonisation of eligible claimants	9.1 Full discretion to Member States 9.2 Natural persons only 9.3 **Natural persons and selected legal persons** 9.4 Natural persons and legal persons

3.1. The need for harmonisation of national IGSs in the European Union

The differences in national approaches towards IGS have resulted in a situation where policyholders across the EU could have different level of protection when their insurer fails. This fragmentation could also have implications for the level-playing field in insurance and the proper functioning of the internal market. Some insurers could benefit from a possible competitive advantage resulting from the existence of an IGS coverage while, at the same time, other insurers could have to contribute to more than one IGS because of the overlaps between schemes. Additionally, consumers could be treated differently across the financial sectors for comparable financial products, such as life insurance products versus saving products offered by banks.

EIOPA assessed three options in its Advice and concluded that the most favourable option was to establish a European network of national IGSs that are sufficiently harmonised across the Member States. This approach would mean that every Member State would have in place a national IGS that meets the minimum harmonised features agreed at EU level.

Table 7 reproduces the evaluation of policy options that EIOPA performed and that supports its conclusion.

Table 7 – Summary of policy options' evaluations – Minimum harmonisation of IGSs

Policy issue 1: Need for harmonisation of national IGSs in the EU						
	Effectiveness (0/+/++)			Efficiency (0/+/++)		
Options	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability
Option 1.1: No change (maintain status quo)	0	0	0	0	0	0
Option 1.2: a European network of sufficiently harmonised national IGSs	++	+	+	++	++	++
Option 1.3: Single EU-wide IGS	++	++	++	+	+	+

With regard to the objectives, such an approach would reduce risks to policyholders. Indeed, although Solvency II significantly improved the supervision of insurers and, hence, reduced the likelihood of insurance failures in the future, it has not fully eliminated this risk. The recent failures of cross-border insurers demonstrated that even in a Solvency II environment, failures of insurers are not completely avoided. EIOPA concludes in that regard that the risk

of policyholders being exposed to potential financial loss and/or social hardship remains real. In addition, normal insolvency procedures are often lengthy[138], expensive and often failed to deliver the Solvency II objective of policyholder protection. Lastly, in the absence of IGS protection losses simply fall either on policyholders or on taxpayers, unless they are dealt with through ad-hoc solutions involving the surviving insurers. An example of such private initiative could be found in the creation of Protektor AG in Germany that took over the insurance portfolio of the failing company, Mannheimer Lebensversicherung AG, in 2002 as a bridge insurer to ensure the continuation of the policies.

The harmonisation of national IGSs would also result in a more even level of protection to policyholders in the event of failures across the Member States. Additionally, it would facilitate cross-border cooperation and coordination between national IGSs, which is essential for the effective and prompt functioning of IGSs in cross-border failures. This is particularly relevant when considering that the cross-border activities in insurance have been increasing over the years and are relatively high. Furthermore, the existence of an effective protection mechanism is likely to enhance the confidence in the industry and, hence, contribute to enhancing the overall financial stability in the EU. Finally, the reliance on public funding and taxpayers' money would be further minimised, which can also contribute to reducing the existing home bias in insurance[139] and the associated sovereign-insurance loop.

The arguments against the set-up of an IGS are the following. Failure incidents have been decreasing for 20 years and Solvency II has further decreased the probability of default. Unlike with deposit protection, there has been, so far, no need to prevent an "insurance run" to safeguard financial stability. The fact that policyholders' claims enjoy a relatively high ranking in the creditor hierarchy should make it possible to pay most insurance claims from the insolvency estate. Therefore, the cost of IGS would be disproportionate. In addition, EIOPA analysis considers that the costs associated with the creation and the management of an IGS feature among the drawbacks of IGSs but that the benefits of minimum harmonisation, such as greater confidence of policyholders in the insurance market, would outweigh these costs. Pointing to the risk of moral hazard created by the existence of a network of IGSs, EIOPA suggests that they can be addressed through their technical features; in particular, the method of calculating insurers' contributions could reflect the risk profile of each contributing insurer.

Some political considerations could also be relevant in the assessment of various options and determine the eventual outcome for the preferred option. A first consideration relates to the positions of Member States. In that perspective, the interactions with Member States in the Commission's expert group showed that 18 Member States broadly supported EIOPA's advice to set up IGSs with different nuances and depending on the desired design, Four Member States were still analysing the possibility of an IGS harmonisation at EU-level in relation to their national systems. Three Member States expressed a negative opinion. A second consideration relates to the need for an adequate balance in the overall package for the Solvency II review in terms of cost for the industry. The design options developed thereafter and the preference expressed assume the choice to pursue with a minimum harmonisation of IGSs in the EU.

[138] Only one quarter of insolvencies are completed within a year, while 38% last longer than two years (EIOPA database of failures and near misses (figures from 2018))
[139] See EIOPA Financial Stability Report – June 2019 and December 2019.

3.2. The harmonisation of the design of national IGSs

3.2.1. Role and functions of IGSs

The majority of the existing schemes in Europe compensate policyholders for their losses in the event of liquidation. Only three IGSs have other roles than compensating policyholders, ensuring the continuation of insurance policies. In addition, EIOPA's survey reveals that eight IGSs have complementary roles, including acting as a temporary or resolution administrator. Despite the fact that most of the existing schemes have a similar role EIOPA stressed that the lack of any harmonised features governing the role and functioning could still result in a situation of uneven levels of policyholder protection, in particular in cross-border cases.

In terms of funding costs, as shown in table 8, the estimations provided by the model developed by the Commission services tend to be slightly lower for IGSs that offer compensation compared to IGSs that ensure the continuation of policies, in particular for the non-life segment.

Table 8 – Funding needs for the EU 27 as per year-end 2018 under the home principle

Source: Joint Research Centre, European Commission

Million EUR	**Continuation Principle**			**Compensation Principle**		
	Life	Non-life	Total	Life	Non-life	Total
PD = 0.05%						
Alpha 1%	6,585	802	7,285	6,338	456	6,732
Alpha 10%	996	125	1,112	958	71	1,028
Alpha 25%	282	36	318	272	20	294
PD = 0.1%						
Alpha 1%	12,255	1,491	13,552	11,795	848	12,523
Alpha 10%	2,114	264	2,359	2,035	150	2,180
Alpha 25%	648	82	728	624	47	673
PD = 0.5%						
Alpha 1%	48,435	5,888	53,539	46,615	3,346	49,474
Alpha 10%	11,636	1,441	12,948	11,199	819	11,965
Alpha 25%	4,344	546	4,861	4,181	310	4,492

This can be explained by the fact that, in the case of continuation, the model developed by the Commission services assumes the need to provide an amount of capital requirements for the policies that are continued (i.e. to recapitalise up to the level needed to ensure the continuation of the policies) in addition to the situation of compensation[140]. In addition, as explained by EIOPA, in most of the cases, the compensation principle will only cover outstanding policyholders' claims at the time of default.

However, from the perspective of policyholder protection and taking into account the social hardship that could be associated with the interruption of insurance coverage, the continuation of policies might be more beneficial, especially for life or health policies and annuities. In this perspective, EIOPA's preferred option is that the role and functioning of IGSs should be the continuation of insurance policies and/or compensation of policyholder claims. EIOPA considers that the objective to protect policyholders in the event of insurance

[140] See the technical report for further details about the calculation of the EAD used to determine the loss amount to be covered

failures can be achieved in several ways. The optimal IGS intervention could depend on the circumstances. For instance, the continuation of policies might be in the best interest of policyholders for life or long-term non-life insurance policies, whereas the swift payment of claims might be the better option in other cases.

Table 9 reproduces the evaluation of policy options that EIOPA performed and that supports this conclusion.

Table 9 – Summary of policy options' evaluations – Roles and functions of IGSs

Policy issue 2: Need for harmonisation of roles and functions of national IGSs						
	Effectiveness (0/+/++)			Efficiency (0/+/++)		
Options	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability
Option 2.1: Full discretion to Member States	0	0	0	0	0	0
Option 2.2: Compensation of claims	+	++	++	+	+	++
Option 2.3: Continuation of policies	+	++	++	+	+	++
Option 2.4: Compensation of claims and/or continuation of policies	++	++	+	++	++	+

The Commission services would **support EIOPA's Advice that both functions should co-exist**. On the one hand, the continuation of policies may be more relevant and appropriate in the context of long-term contracts and considering the likely (increasing with time) difficulties for policyholders to replace their policies (against similar conditions) with another insurer. On the other hand, compensation tends to be more appropriate for short-term contracts that would be substituted easily. However, as policyholders could suffer significant losses if they have an outstanding claim at the time of failure, all non-life policies where financial and social hardship cannot be expected to be manageable should also be covered.

3.2.2. Geographical scope

The geographical scope determines whether policies sold on a cross-border basis are covered by the domestic IGS in a particular Member State. National IGSs could be operated based in the home- or the host-country principle. The home country principle means that the IGS covers only policies written by insurers established in the Member State of the IGS, including those sold to policyholders in other Member States (outward). The host country principle means that the IGS covers only policies of residents of the Member State of the IGS, including those purchased from insurers in other Member States (inward).

Based on the information collected by EIOPA, nine IGSs are operated based on the host-country principle, seven on the home-country principle and eight IGSs on a combined approach. For the latter, it appears that one of the principles is usually dominant. In the context of passporting, the absence of and the substantial differences in the design features of existing IGSs, notably in terms of geographical coverage, results in gaps and overlaps that have shown to undermine the credibility and integrity of the Single Market, including for insurers. While holding the same type of insurance policy, policyholders might benefit from a

different level of IGS protection depending on where they live and where they have contracted the policy.

EIOPA analysed the following options:

- Option 1 – Full discretion to Member States
- Option 2 – Home-country principle
- Option 3 – Host-country principle
- Option 4 – Host-country principle plus cooperation (incl. recourse) arrangements
- Option 5 – Home- plus host-country principle (combined approach)

The first option has been disregarded because it would not meet the main objective of ensuring an even and comprehensive protection of policyholders across the EU. Setting harmonised features for the geographical coverage of IGSs is essential to ensure that policyholders in the EU are adequately protected and that the identified problems drivers are addressed.

The main advantage of the home-country principle is that it aligns with – and reinforces – the responsibility of the Home supervisor for the prudential regulation, supervision, resolution and winding-up process of insurers. Under this option, the costs of a cross-border failure would be borne by the industry of the Member State that was responsible for the supervision of insurers that exported their policies and benefitted from EU-wide passporting. This approach would enhance market discipline and incentives to monitor adequately exporting insurers and thereby contribute to a greater confidence in the cross-border provision of insurance services. It would also allow for a non-discriminatory system in which policyholders of the same insurers, wherever their place of residence, are equally protected. Finally, an important consideration supporting the home country principle highlighted in the 2010 White Paper is that the administration of an IGS is closely linked with rules regarding insolvency and liquidation, which are under the responsibility of the Home Member State. In the public consultation organised by EIOPA[141], most respondents supported the home approach.

While a host-country principle would ensure that all policyholders in a given Member States are evenly protected, regardless of the location of their insurer, it would require, in principle, incoming insurers to participate in all domestic IGSs where they have operations. This could duplicate administrative costs, as it would require insurers with cross-border business to take part in two or more IGS. In addition, this option would not contribute to the alignment and reinforcement of supervisory responsibilities and market discipline that would be achieved under the home-country principle[142]. This could further hinder the IGS intervention by creating additional frictions. EIOPA notes that when the choice is made not to require inward insurers to contribute, on the same terms than insurers in the host Member State, to the host IGS, recourse against the IGS of the Home Member State of the failed insurance group where it exists would be needed. The example of France that is provided by EIOPA in box 13.5 of its background analysis shows the absence of recourse mechanism could result in a reduction of coverage and a decrease in the overall protection provided to policyholders.

In terms of funding, the difference between the two approaches is shown in the following tables. At EU level, the two approaches deliver broadly similar results. The difference is

[141] https://www.eiopa.europa.eu/sites/default/files/solvency_ii/eiopa-bos-20-752-feedback-statement.pdf

[142] A resolution authority or an administrator may focus on the interests of creditors and policyholders in their own jurisdiction, e.g. by ring-fencing the capital instead of using it to cover capital shortages in other Member States. Supervisors may have reduced incentives to supervise insurers that concentrate on freedom of establishment and freedom of services if their jurisdiction does not bear financial responsibility in case of failure of the insurer.

explained by the slightly different level of funding needs estimated by the model between the cross-border activities that are imported (covered by the host-country based system) and those that are exported (covered by the home-country based system).

The funding needs of a host-country based system for both life and non-life would be slightly increased by some 0-1% compared with a home-country based system. However, the funding needs of a host-country based system would be slightly reduced by some 0-1% compared with a home-country based system if we consider non-life activities only.

Table 10 – Funding needs for the EU 27, Home IGS vs. Host IGS, compensation principle, 2018

Source: Joint Research Centre, European Commission

Million EUR		PD = 0.05%			PD = 0.1%			PD = 0.5%		
		75%	90%	99%	75%	90%	99%	75%	90%	99%
TOTAL	HOME	294	1,028	6,732	673	2,180	12,523	4,492	11,965	49,474
	HOST	294	1,028	6,735	673	2,181	12,529	4,494	11,971	49,497
	Var.	≅	≅	**-0.04%**	≅	**-0.05%**	**-0.05%**	**-0.04%**	**-0.05%**	**-0.05%**
LIFE	HOME	272	958	6,338	624	2,035	11,795	4,181	11,199	46,615
	HOST	272	961	6,352	625	2,039	11,821	4,190	11,224	46,720
	Var.	≅	**-0.31%**	**-0.22%**	**-0.16%**	**-0.20%**	**-0.22%**	**-0.21%**	**-0.22%**	**-2.22%**
NON-LIFE	HOME	20	71	456	47	150	848	310	819	3,346
	HOST	20	71	455	47	149	845	310	817	3,337
	Var.	≅	≅	**-0.22%**	≅	**+0.67%**	**+0.36%**	≅	**+0.24%**	**+0.27%**

Table 11 – Funding needs for the EU 27, Home IGS vs. Host IGS, continuation principle, 2018

Source: Joint Research Centre, European Commission

Million EUR		PD = 0.05%			PD = 0.1%			PD = 0.5%		
		75%	90%	99%	75%	90%	99%	75%	90%	99%
TOTAL	HOME	318	1,112	7,285	728	2,359	13,552	4,861	12,948	53,539
	HOST	318	1,113	7,288	728	2,360	13,558	4,863	12,954	53,564
	Var.	≅	**-0.09%**	**-0.04%**	≅	**-0.04%**	**-0.04%**	**-0.04%**	**-0.05%**	**-0.05%**
LIFE	HOME	282	996	6,585	648	2,114	12,255	4,344	11,636	48,435
	HOST	283	998	6,600	649	2,119	12,282	4,354	11,662	48,543
	Var.	**-0.35%**	**-0.20%**	**-0.23%**	**-0.15%**	**-0.24%**	**-0.22%**	**-0.23%**	**-0.22%**	**-0.22%**
NON-LIFE	HOME	36	125	802	82	264	1,491	546	1,441	5,888
	HOST	36	124	800	82	263	1,487	545	1,437	5,872
	Var.	≅	**+0.81%**	**+0.25%**	≅	**+0.38%**	**+0.27%**	**+0.18%**	**+0.28%**	**+0.27%**

The fourth option considered by EIOPA introduces the possibility to have a recourse to the IGS of the home Member State of the failed cross-border insurer. However, this option assumes that (a) there would be a Home IGS to which a recourse could be introduced and (b) that the scope of coverage would be identical between the home and the host IGSs. The last option considered by EIOPA is a combined approach. As for the preceding one, EIOPA stresses the significant complexity added by this option. There seems to be no clear benefits of these options in comparison to the home approach with a minimum harmonisation of the IGS design.

An additional option, that was considered in the 2010 White Paper (see option 5.4), would be to implement a harmonised IGS system that would only cover cross-border activities, i.e.

policies written and sold cross-border via branches and/or free provision of services. This would address the specific problems that arise in the cross-border context and that were illustrated by some of the recent cases of failure. National flexibility would be maintained for the purely domestic business. In practice, however, such a solution is likely to create a number of complications. First of all, an EU-wide IGS for cross-border business would not be consistent with the existing national micro-prudential supervisory framework. Furthermore, insurers with cross-border business would need to take part in both the cross-border scheme and their national scheme. Uneven protection levels between and within Member States would also continue, especially if domestic and cross-border business protection were different. Overall, the funding needs for the EU under this option, considering the need for adequate IGS protection at domestic level (i.e. mandating an IGS in all EU Member States), are broadly the same. The funding needs for an EU-wide IGS covering cross-border insurance activities being relatively limited as can be seen in the table 12.

Table 12 – Funding needs for the EU 27, cross-border IGS – exported business, compensation, 2018

Source: Joint Research Centre, European Commission

Million EUR	**PD = 0.05%**			**PD = 0.1%**			**PD = 0.5%**		
	75%	**90%**	**99%**	**75%**	**90%**	**99%**	**75%**	**90%**	**99%**
TOTAL	21	75	491	49	159	913	327	872	3,607
LIFE	19	69	455	45	146	846	300	804	3,345
NON-LIFE	2	5	34	3	11	64	23	61	251

Absent the domestic element, i.e. an IGS applicable only to insurers that sell insurance services cross-border, the costs for the industry overall could be reduced. However, policyholders living in a Member State without an IGS for its residents would only be protected if their insurance policies are covered by an insurer from abroad, which contradicts the objective of a minimum level of protection for all policyholders. In addition, contributions to such a protection scheme could present a disincentive for conducting cross-border business.

Table 13 reproduces the evaluation of policy options that EIOPA performed and that supports this conclusion.

Table 13 – Summary of policy options' evaluations – Geographical scope

Policy issue 3: Need for harmonisation of geographical of national IGSs						
	Effectiveness (0/+/++)			Efficiency (0/+/++)		
Options	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability
Option 3.1: Full discretion to Member States	0	0	0	0	0	0
Option 3.2: Home-country principle	++	++	++	++	++	++
Option 3.3: Host-country principle	++	++	+	++	++	+
Option 3.4: Host-country principle plus recourse arrangements	++	++	+	++	++	+
Option 3.5: Home- plus host-country principle (combined approach)	+	+	+	+	+	+

Based on its analysis, Commission services would **support EIOPA's preference for the home-country principle**. In addition to the elements described above and the consistency with the approach followed for DGS and ICS, this option would ensure that all policyholders of a failing insurer would be enjoy the same scope and level of IGS protection irrespective of their place of residence. However, this solution requires the minimum harmonisation of the main IGS features for two reasons. If the level of protection through the IGS would be left entirely to the respective Home Member State, the home country approach would be difficult to accept for Member States that have currently chosen to establish an IGS based on the host principle. This choice underlies the willingness to protect all their residents to the same scope and level irrespective of where their insurer is established. Only option 2 with minimum harmonised features would establish such a minimum floor of policyholder protection in case of an insurer's failure throughout the Single Market.

In terms of costs, the implementation of option 2 would represent a maximum of 13.6 billion EUR for the entire EU[143], assuming an extensive scope covering all life and non-life policies. Assuming a 10-year transition period to accumulate the financial resources of the IGS, this estimated amount would correspond to an overall cost increase at EU-level for the industry and policyholders of about 1.50 EUR per year on a yearly premium of 1,000 EUR.

3.2.3. Eligible policies

EIOPA analysed the following options as regards eligible policies.

- Option 1 – full discretion to Member States
- Option 2 – Life policies only
- Option 3 – Non-life policies only
- Option 4 – Both life and non-life policies
- Option 5 – Specific life and specific non-life policies

[143] The sum of the individual funding needs per Member State could be slightly higher as they would not reflect diversification effects that are inherent to the model. This result reflects a probability of default of 0.1% and a confidence interval of 99%, meaning that in one loss event out of 100, the resources provisioned by the Fund will not be sufficient to cover the incurred loss. This estimation depends on selected elements such as the confidence interval, the assumed probability of default of insurers and the IGS design.

According to EIOPA, most of the existing IGSs are special schemes covering typically one or two types of policies. Seven national IGSs cover a broad range of both life and non-life insurance policies, whereas the other seven schemes cover only life or non-life policies. In order to ensure a minimum level of equal protection of policyholders, EIOPA considers it is essential to establish harmonised features for insurance policies eligible for IGS protection. Option 1 would thus be disregarded, as it would not meet the main objective of an EU action.

Life insurance is characterised by long-term duration contracts with usually a savings or retirement objective. The financial consequences for policyholders could be significant if insurers cannot meet their contractual commitments on life policies, especially when they rely on the pay-outs of their policies, for instance, for their retirement in the form of savings or annuities. In addition, the typical long-term nature of life products in combination with the likely difficulties for policyholders to find replacement (against similar conditions) makes IGS protection essential.

As regards non-life insurance, most non-life insurance is characterised by short duration contracts, which could easily be substituted. However, even if the average loss to policyholders is generally smaller in the case of a non-life insurer going into default, there are instances where losses to individual policyholders and third party claimants may well exceed that of a typical life insurance product. Policyholders could also suffer significant losses if they have an outstanding claim at the moment of failure.

Therefore, since substantial losses can be passed on to the holders of both life and non-life policies, policyholders will receive a more complete and appropriate protection if the EU acts to protect both types of policy – albeit in different ways and under different rules. However, doubts exist, also in view of the comments of some stakeholders, on whether this full coverage is entirely justified.

Table 14 reproduces the evaluation of policy options that EIOPA performed and that supports this conclusion.

Table 14 – Summary of policy options' evaluations – Eligible policies

Policy issue 4: Need for harmonisation of eligible policies						
	Effectiveness (0/+/++)			Efficiency (0/+/++)		
Options	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability
Option 4.1: Full discretion to Member States	0	0	0	0	0	0
Option 4.2: Life policies only	+	+	+	+	+	+
Option 4.3: Non-life policies only	+	+	+	+	+	+
Option 4.4: Both life and non-life policies	++	++	+	+	+	+
Option 4.5: Selected life and selected non-life policies	++	++	+	++	+	+

The Commission services would **support EIOPA's advice that recommends IGS to cover specific life and specific non-life policies**. As EIOPA mentions that the protection for life policies is essential to alleviate the potential severe financial and social hardship for

policyholders and beneficiaries all life policies should be covered. In the consultation that EIOPA organised, the difficulty to appreciate fully the criteria of financial and social hardship was stressed several times by stakeholders. In this perspective, leaving the discretion of the definition of the scope of eligible policies to Member States based on these criteria risks missing the main objective of EU action. Therefore, it might be preferable to establish a minimum list of eligible non-life policies at EU level based on the list that EIOPA presents. Member States would nevertheless maintain the flexibility to go beyond the specific range of policies set at the EU level and extend the coverage to a broader range of policies.

In terms of funding, the definition of eligible policies would have a significant impact on the costs for IGSs. Certain lines of business present higher costs than others and the possibility to cover multiple lines of business could also create some pooling or diversification effects that could be beneficial overall.

The following table presents the costs of funding per lines of business and on an aggregated level for the entire EU for both the compensation and the continuation principles[144].

Table 15 – Funding needs per lines of business, Home-country principle, 2018

Source: Joint Research Centre, European Commission

This table provides an overview of the funding needs for an IGS at different level of granularity in terms of eligible policies under the home-country principle and considering the two principles for IGS intervention, i.e. compensation or continuation. The information is provided under the assumption of a probability of default of 0.1% and for different levels of security to be achieved by the IGS protection: 75% (alpha=25%) of failure cases, 90% (alpha=10%) of failure cases and 99% (alpha=1%) of failure cases.

EU 27 (Million EUR)	**Continuation Principle**			**Compensation Principle**		
	Alpha 1%	***Alpha 10%***	***Alpha 25%***	***Alpha 1%***	***Alpha 10%***	***Alpha 25%***
Total	13,552	2,359	728	12,523	2,180	673
Life	12,255	2,114	648	11,795	2,035	624
Annuities Health	*60*	*10*	*3*	*59*	*10*	*3*
Annuities Non-health	*20*	*3*	*1*	*20*	*3*	*1*
Health Ins.	*768*	*132*	*41*	*721*	*124*	*38*
Index- and Unit-linked	*2,986*	*515*	*158*	*2,836*	*489*	*150*
Profit Part.	*7,627*	*1,316*	*403*	*7,417*	*1,279*	*392*
Other Life	*755*	*130*	*40*	*702*	*121*	*37*
Non-Life	1,491	264	82	848	150	47
Credit/Surety	*37*	*7*	*2*	*21*	*4*	*1*
Fire/Property	*382*	*67*	*21*	*199*	*35*	*11*
General Liability	*304*	*54*	*17*	*231*	*41*	*13*
Income Protection	*167*	*30*	*9*	*104*	*18*	*6*
MAT	*39*	*7*	*2*	*23*	*4*	*1*
Medical Exp.	*249*	*44*	*14*	*120*	*21*	*7*
Workers Comp.	*19*	*3*	*1*	*14*	*3*	*1*

[144] The figures presented in table 15 are in relation to a probability of default of 0.1%.

3.2.4. Coverage level

The coverage level determines the design and extend of protection provided to policyholders and beneficiaries. Currently, national IGSs have varying coverage levels. Table 16 provides some examples of the (maximum) coverage levels in place for some of the existing IGSs.

Table 16 – Coverage levels of existing national IGSs (excluding MTPL)

Source: EIOPA background analysis, European Commission

Country	Coverage level	Policies covered
BE	EUR 100,000 per claimant	Insurance with profit participation
BG	Approx. EUR 25,000 per injured person	Compulsory accident insurance of passengers in the means of public transport vehicles
	Approx. EUR 100,000	Insurance with profit participation, index-linked and unit-linked insurance and other life insurance
DE	Continuation principle with no specific limit	Life and health policies
EL	▪ 100% or maximum of EUR 30,000 per claimant for life ▪ 100% or maximum of EUR 60,000 for death and permanent total disability	Broad range of life policies (survival, death insurance, annuities, accident or sickness, marriage and birth, investment, health, etc.)
FI	100% of claims	Workers' compensation insurance and patient injuries insurance
FR	EUR 90,000 per claimant (health)	Health insurance policies
	EUR 70,000 per claimant (life)	Life insurance policies
	90% of the compensation to policyholders	Third party medical malpractice liability
	90% of the compensation to policyholders	Assurance "dommages-ouvrage" (covers the construction of a new building)
IT	▪ Approximately EUR 500,000 for each accident ▪ Approximately EUR 400,000 for each injured person ▪ Approximately EUR 100,000 for damage to animals and property	Civil liability towards third parties deriving from the use of weapons or tools for hunting.
IE	65% or a maximum of 825,000 per claimant	Broad range of non-life policies
LV	100% or maximum of EUR 15,000 per claimant for life, 50% or maximum of EUR 3,000 for non-life	Broad range of life and non-life policies
MT	75% or maximum of approx. EUR 24,000 per claimant	Broad range of life and non-life policies
NO	90% or maximum EUR 2.1 million per claimant	Broad range of life and non-life policies
PL	EUR 30,000 but not more than 50% of the claims	Broad range of life policies (life, marriage and birth, unit linked,

		annuity, accident and sickness)
	100% of the claims up to the sum insured	Compulsory insurance for farm buildings
	100% of the claims up to a minimum amount (EUR 5,210,000 for personal injuries per event and EUR 1,050,000 for damages to property per event)	Compulsory farmers third party liability insurance
	EUR 30,000 but not more than 50% of the claims	Compulsory professional third party liability insurances
RO	Approximately EUR 92,000 maximum per claimant	All life and non-life policies

In determining the coverage level, an appropriate balance has to be found between, on the one hand, the protection offered to policyholders and beneficiaries against an undesirable level of financial or social hardship and, on the other hand, the overall costs of funding the protection scheme.

In order to reach this balance, EIOPA recommends the following main elements to design the minimum harmonised coverage system:

- 100% of a certain amount (e.g. EUR 100,000) should be guaranteed for selected eligible policies associated to social hardship (e.g. health, savings). Beyond this EUR amount, a percentage cap of coverage level should be considered. EIOPA's advice and background analysis imply that this design would preferably apply to all life policies.
- For other policies, the maximum coverage in terms of a percentage cap could apply[145]. EIOPA's advice and the related background analysis imply that this design would apply mainly to selected non-life policies.
- EIOPA also recommends a deductible amount should also be defined for the eligible policies (e.g. EUR 100), which should act as a minimum threshold, below which no eligible policy would be covered by the IGS. However, considering that most insurance contracts already include a deductible amount, the definition of a harmonised deductible amount would be an unnecessary complication in the design of the coverage level. As the IGS intervention would reflect the terms of the contract between the failing insurer and its policyholders, thereby defining the eligible claim, the deductible amount of the contract will be reflected and should be sufficient to prevent moral hazard behaviour on the side of policyholders or unjustified administrative costs in comparison to the amount claimed.

EIOPA did not provide any quantitative analysis to help defining these different elements. Absent available information on the distribution of claims in the Member States, it has not been possible for the Commission services to provide estimations based on its model. However, the Commission services ran a survey on the main features of current IGSs in the context of its Expert Group on Banking, Payment and Insurance (EGBPI) meetings. As a principle, IGSs would not cover more than the contractual obligations of insurers towards their policyholders but they could cover less. The different thresholds could be set at a level that could be regarded as a reasonable compromise between the currently applicable levels across Member States that have one or more IGS(s) in place.

[145] EIOPA notes that, in case of a continuation model, it may be that absolute caps are not needed. We understand that it will depend on the sustainability of the costs associated with the implementation of the continuation model (e.g. the importance of the haircut applied to policyholders' claims, to be covered by the IGS acting as a facilitator, in the case of a transfer).

Based on EIOPA's recommendation and the results of its survey, the Commission services considered the following options:

- Option 1 – determine a single minimum ceiling (e.g. EUR 100,000) across Member States.
- Option 2 – determine a minimum ceiling and a percentage share for life, and only a percentage share for non-life insurance.

Option 1 would be a simpler starting point for minimum harmonisation and would correspond to the approach in several Member States as shown by the survey's results and EIOPA's examples. However, a single minimum ceiling of EUR 100,000, for instance, could still lead to significant social hardship in case significant damage remained uncovered, e.g. for fire or civil liability insurance, in particular concerning uncovered claims of injured third parties.

Option 2 reflects further EIOPA's recommendation. In comparison to Option 1, this approach remains simple and its additional coverage of a share of higher claims would make the minimum harmonisation approach credible. Using the current maximum levels of coverage achieved in Member States that already have an IGS in place and having in mind the need to take account of the varying living standards, a harmonised share of 85% would seem appropriate.

In conclusion, the Commission services would **follow the structure recommended by EIOPA and believe that Option 2 would be preferable**.

3.2.5. Funding

3.2.5.1. Timing of funding

Based on EIOPA's survey, a bit more than a third of existing IGSs are funded ex-ante while slightly less than a third are funded ex-post and one third of existing IGSs are funded by a combination of both approaches. The OECD made a similar observation in 2013[146].

Table 17 below summarizes the pros and cons of each approach as provided in EIOPA's background analysis. This overview confirms analyses made by both the OECD[147] and the IAIS[148] in 2013.

Table 17 – Overview of the pros and cons between ex-ante and ex-post funding

Source: EIOPA's background analysis

	Advantages	Disadvantages
Ex-ante funding	▪ Swift intervention ▪ Lower moral hazard ▪ Lower procyclicality	▪ Higher industry costs (addressed with a transitional period) ▪ Higher management/operational costs ▪ Investment risk
Ex-post funding	▪ Lower management/operational costs ▪ No investment risk ▪ Reflects actual needs	▪ Higher moral hazard ▪ Higher execution risk ▪ Higher procyclicality

[146] https://www.oecd-ilibrary.org/policyholder-protection-schemes_5k46l8sz94g0.pdf?itemId=%2Fcontent%2Fpaper%2F5k46l8sz94g0-en&mimeType=pdf
[147] See previous footnote.
[148] https://www.iaisweb.org/page/supervisory-material/issues-papers/file/34547/issues-paper-on-policyholder-protection-schemes

Ex-post

In an ex-post funded scheme, resources remain with the contributing institutions until a failure occurs, and levies are paid to the scheme only once losses arise. It follows that set-up and operational costs are limited and that the funds are collected based on actual needs (i.e. outstanding claims). However, ex-post funding is more subject to moral hazard as failed institutions never contributed to the IGS. This could incentivise insurance companies to adopt less conservative and riskier practices in order to maximise their profits and extract values from policyholders as they would not have to face the consequences of these inappropriate behaviours. Furthermore, depending on the market circumstances and the degree of market concentration, raising contributions following the failure of an insurer could potentially have a pro-cyclical effect on the surviving share of the industry.

As summarised in table 17, the main advantages of ex-post funding are:

- A very low set-up and administrative costs;
- A lower cost for insurance undertakings as long as no failure occurs;
- Collected funds are tailored on actual default losses.

The main disadvantages are:

- A difficulty to ensure a prompt pay-out to policyholders without recourse to lending by the IGS, which may not be feasible during a financial crisis, or to public funds;
- Failed insurance undertakings do not contribute to the loss caused by their failure;
- Funds are collected in a possibly more pro-cyclical way and the reliance on public funds, could – in extreme cases – reinforce the sovereign-insurer loop[149];
- An uncertainty on the possibility to collect funds from the insurance industry depending on the circumstances at the moment of the failure.

Ex-ante

In a pre-funded scheme, funds are raised in anticipation of possible future failures, with resources transferred to, and managed by, the IGS via a system of levies on industry.

The first advantage therefore is the fact that money is readily available to protect policyholders and beneficiaries should a failure occur. Moreover, ex-ante funding is less subject to moral hazard problems because insurers that become insolvent will have already contributed to the IGS[150]. Finally, ex-ante funding is more likely to avoid the pro-cyclicality associated with ex-post funded schemes. However, the set-up and operational costs tend to be higher in a pre-funded scheme than in the case of ex-post funding. In addition, the investment policy of the scheme should be adequately framed to ensure that the financial resources remain available when needed.

As shown in table 17, the main advantages of ex-ante funding are:

- Funds are more quickly available to the IGS;
- Failed insurers contribute to the loss caused by their failure;
- Funds are collected in a possibly less pro-cyclical way.

The main disadvantages are:

- Higher set-up, administrative and operational costs.

[149] See EIOPA Financial Stability Report of December 2019 for an analysis of the existing home-bias in insurance.

[150] This positive feature of ex-ante funded IGS can be reinforced by introducing ex-ante levies that are risk-weighted.

Combination of ex-post and ex-ante funding

When part of the IGS funding is ex-ante and part is ex-post, some of the funds would be immediately available to the IGS without imposing too high ex-ante costs / mobilization of funds on industry and policyholders.

Table 18 reproduces the evaluation of policy options that EIOPA performed and that supports this conclusion.

Table 18 – Summary of policy options' evaluations – Timing of funding

Policy issue 6: Need for harmonisation of timing of funding						
	Effectiveness (0/+/++)			Efficiency (0/+/++)		
Options	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability	Objective 1: Effective and efficient policyholder protection in resolution and/or liquidation	Objective 2: Ensuring a level playing field through sufficiently harmonised rules	Objective 3: Improving transparency and better comparability
Option 6.1: Full discretion to Member States	0	0	0	0	0	0
Option 6.2: Ex-ante funding	+	+	+	+	+	+
Option 6.3: Ex-post funding	+	+	+	+	+	+
Option 6.4: Ex-ante funding complemented with ex-post funding	++	+	+	++	+	+

The above analysis would support EIOPA's advice that states that **IGSs should be funded on the basis of ex-ante contributions by insurers, possibly complemented by ex-post funding arrangements in case of capital shortfalls and that further work is needed in relation to specific situations where a pure ex-post funding model could potentially work, subject to adequate safeguards.** It would underpin the necessary trust that the home-country approach will actually deliver the agreed protection and the complementary ex-post funding arrangements, combined with an appropriate transition period to reach the target level, could alleviate some of the concerns of those stakeholders opposed to a pure ex-ante funding. However, the overall balance of the Solvency II review needs to be considered in view of the additional costs for the industry. In this perspective, the choice of the timing of funding may also need to reflect that some insurance products have more limited payout and maturity profiles. This consideration may be suitable to balance adequately the interest of all stakeholders involved and combine, as suggested by EIOPA, ex ante and ex post funding in an appropriate manner.

3.2.5.2. Nature of contributions to IGSs

According to EIOPA, more than half of the existing IGSs collect flat-rate (fixed) contributions while less than a third operate on the basis of variable-rate contributions. Only one IGS currently uses risk-based contributions.

The main advantages of contributions based on a flat-rate in proportion to the size of insurers' business are the simplicity of the approach and the consistency with current schemes.

However, while a flat-rate system distinguishes between insurers based on their volume of activities, it does not account for different levels of conservatism in their investment policy or underwriting risk-pricing approach. This could be conducive to moral hazard as the risks of certain companies would ultimately be borne by others[151]. This has been confirmed by the 2013 OECD analysis that considered that since non-risk-based premiums do not reflect the riskiness of the insurer (i.e. riskier activities are not "penalised" by higher levies), they can lead to a cross-subsidisation of funding among insurers participating in the scheme.

EIOPA is also of the view that a risk-based system would lead to a fairer allocation of costs. In addition, a risk-based system would better incentivise insurers to manage their risks adequately, including when insurance services are offered abroad, thereby contributing to a system-wide strengthening of the insurance market and thus contributing to the overall objectives of Solvency II.

The Commission services therefore **would consider that a risk-based system of contributions would be preferable**.

As to the level of IGS contributions, EIOPA reports that half of the existing IGSs have some type of upper limit on the annual level of contributions that can be raised from an individual insurer or from the industry as a whole.

Considering minimum harmonisation, Member States could determine the level at which insurance undertakings should contribute annually to the IGS funds, as long as the target level is reached after a harmonised transition period.

3.2.5.3. Target level

IGS are designed to cover the most extreme losses that occur with a very low probability. Assuming that IGS would be ex-ante funded, EIOPA is of the opinion that an appropriate target level for the funding of IGSs should be defined across Member States (minimum level of capital to be maintained in the scheme), taking into account the national market specificities. This would ensure that IGSs have sufficient capacity to absorb losses. The table 19 below illustrates the choice in terms of target level.

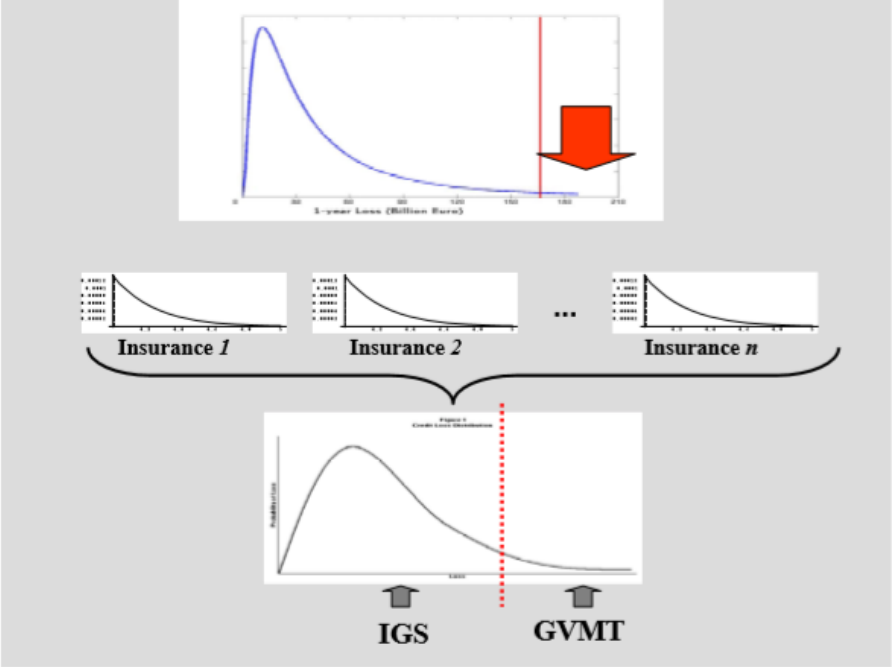
Table 19 – IGS size/funding in terms of coverage of a risk of failure

Source: European Commission, White Paper, 2010

The vertical red line shows the cut-off point up to which a chosen level of IGS funding will be able to protect policyholders from losses. The level of security (or confidence level) provided to policyholders, or the risk appetite of the regulation, is determined in relation to the part (or, statistically, the percentile or "1-alpha" in the model) of the IGS loss distribution that the IGS financial resources can cover. When the financial resources are, for example, sufficient to cover the IGS loss distribution up to the, for example, 90th percentile, this means that the level of security chosen avoids that losses are passed on to policyholders in 90% of the cases possible. In other terms, it can also be said that if the financial resources cover the IGS loss distribution up to the 75th ,90th, 99th percentile, the IGS is expected to have not enough resources and therefore pass losses onto

[151] In addition, the academic literature provides ample evidence-based demonstration of the risk-shifting behaviour of insurers in presence of a flat-rate IGS. Lee et al. (1997) for instance provide evidence that the risk of stock insurers' asset portfolios increases following enactments of a flat-rate ex-post IGS. Downs and Sommer (1999) find that a flat-rate ex-post IGS induces stock insurers to take more risk, and furthermore that less capitalized insurers are more likely to conduct risk-shifting. Lee and Smith (1999) find that the flat-rate IGS induces insurers to lower their reserves and substitute IGS coverage for capital. In a theoretical study, Schmeiser and Wagner (2010) find that in a competitive market setting, introducing a flat-rate ex-ante IGS entails a shift of the insurer's equity capital towards minimized solvency requirements, leading to higher insolvency probabilities.

policyholders only every 4, 10, 100 years.



The target fund of an IGS would be influenced by many parameters, among which two appear to be the most important: the probability of default (PD) of insurers and the level of targeted security for policyholders. As has been set out above, the "average over-the-cycle" PD for insurers used in the model were set at different levels ranging between 0.05% and 0.5%. Besides the probability of default of insurance undertakings, IGS funding needs are mostly influenced by the level of security provided to policyholders and beneficiaries: the higher the security provided by an IGS, the higher the required IGS funding needs. A key decision would therefore be the level of security that an IGS is expected to provide to policyholders.

The confidence level chosen should not only provide a high level of security for policyholders and beneficiaries but also be financially realistic, i.e. it should have the potential to achieve the objective of a sufficiently high protection of policyholders, without requiring excessive resources. As in the 2010 White Paper, three funding levels are considered: 75%, 90%, and 99%.

The following list of policy options (see technical report, tables 7 to 14 for an estimation of the level of funding under various assumptions) can be drawn up with regard to the level of IGS financial resources, taking into consideration both the probability of default of insurers and the level of security for consumers:

- Option 2.1: No action (harmonization) at EU level
- Option 2.2: Harmonization at EU level
  - Sub-option 2.2.1: Low risk, low security (PD=0.05%, percentile=75%)
  - Sub-option 2.2.2: Low risk, medium security (PD=0.05%, percentile=90%)
  - Sub-option 2.2.3: Low risk, high security (PD=0.05%, percentile=99%)
  - Sub-option 2.2.4: Medium risk, low security (PD=0.1%, percentile=75%)
  - Sub-option 2.2.5: Medium risk, medium security (PD=0.1%, percentile=90%)
  - Sub-option 2.2.6: Medium risk, high security (PD=0.1%, percentile=99%)
  - Sub-option 2.2.7: High risk, low security (PD=0.5%, percentile=75%)
  - Sub-option 2.2.8: High risk, medium security (PD=0.5%, percentile=90%)

– Sub-option 2.2.9: High risk, high security (PD=0.5%, percentile=99%)

While option 2.1 is inconsistent with the objective of providing a high and even level of protection to policyholders in all Member States, the choice between the various sub-options in option 2.2 clearly depends on a cost-benefit analysis.

IGS cannot be pre-funded to a level necessary (nor should be constructed in the perspective) to deal alone with the biggest failures, but their capacity to do so obviously increases when financial resources are higher. An analysis of the funding needs of an IGS should also take into account the annual costs that a certain funding may impose on the industry and on the society, in case resources are anticipated but losses do not eventually materialise.

The estimated funding needs and costs (assuming a 10-year transition period) associated with these options are summarized in table 20 below under various security and probability of default assumptions for a home-country based system and a continuation principle. Results remain broadly in line with those estimated in the 2010 White Paper.

Table 20 – Funding needs and costs under various security assumptions, Home Principle, 2018

Source: Joint Research Centre, European Commission

The yearly cost increase (in EUR), assuming a 10-year transition period, associated with each assumption in terms of level of security are represented in parenthesis for a yearly premium of EUR 1,000. The percentile represents a desired level of security; it corresponds to 1-Alpha.

EU 27 (Million EUR)	**PD = 0.05%**			**PD = 0.1%**			**PD = 0.5%**		
Percentile	*99%*	*90%*	*75%*	*99%*	*90%*	*75%*	*99%*	*90%*	*75%*
Total	7,285 (0.81)	1,112 (0.12)	318 (0.04)	**13,552 (1.50)**	2,359 (0.26)	728 (0.08)	53,539 (5.93)	12,948 (1.44)	4,861 (0.54)
Life	6,585 (1.14)	996 (0.17)	282 (0.05)	12,255 (2.12)	2,114 (0.37)	648 (0.11)	48,435 (8.37)	11,636 (2.01)	4,344 (0.75)
Non-life	802 (0.25)	125 (0.04)	36 (0.01)	1,491 (0.46)	264 (0.08)	82 (0.03)	5,888 (1.82)	1,441 (0.45)	546 (0.17)

However, given the variability between individual markets, showing results based on EU 27 aggregates could not be sufficiently representative of the cost necessary to achieve a desired level of comfort at Member States level. Table 21 below therefore presents the funding costs, assuming a yearly premium of 1,000 EUR and a 10-year transition period, with reference to the proportion of Member States that would reach the desired level of protection, assuming a certain probability of default and a certain percentile. For the purpose of the presentation, only the two higher percentiles (i.e. 99% and 90%) have been considered.

Table 21 – Share of Member States covered at a given cost of funding, Home Principle, 2018

Source: Technical report, table 7 –, European Commission

Each cell of the table represents the funding costs, under the continuation principle, for a yearly premium of EUR 1,000, assuming a 10-year transition period, that is associated to (a) a certain probability of default within the industry, (b) a level of security and (c) a proportion of Member States covered at the desired security level. The corresponding estimates for the total funding needs in million EUR are

provided in parenthesis (see technical report, table 8).							
EU 27 (EUR)		**PD = 0.05%**		**PD = 0.1%**		**PD = 0.5%**	
Percentile		*99%*	*90%*	*99%*	*90%*	*99%*	*90%*
Lines of Business	**Member States**						
Total	*75%*	0.80 (7.2)	0.11 (1.0)	**1.49** **(13.4)**	0.24 (2.2)	5.89 (53.1)	1.36 (12.3)
	90%	1.08 (9.8)	0.15 (1.3)	**2.02** **(18.2)**	0.32 (2.9)	8.02 (72.4)	1.70 (15.4)
	MAX	1.24 (11.2)	0.16 (1.4)	**2.33** **(21.0)**	0.35 (3.1)	9.28 (83.8)	2.00 (18.0)
Life	*75%*	1.21 (7.0)	0.16 (0.9)	**2.26** **(13.1)**	0.37 (2.1)	9.95 (57.5)	2.03 (11.7)
	90%	1.77 (10.2)	0.21 (1.2)	**3.31** **(19.1)**	0.45 (2.6)	13.19 (76.3)	2.57 (14.9)
	MAX	2.99 (17.3)	0.42 (2.4)	**5.57** **(32.2)**	0.90 (5.2)	22.10 (127.8)	5.06 (29.3)
Non-life	*75%*	0.26 (0.8)	0.03 (0.1)	**0.49** **(1.6)**	0.08 (0.3)	2.00 (6.5)	0.44 (1.4)
	90%	0.47 (1.5)	0.05 (0.2)	**0.89** **(2.9)**	0.11 (0.4)	3.65 (11.8)	0.64 (2.1)
	MAX	0.61 (2.0)	0.08 (0.3)	**1.14** **(3.7)**	0.17 (0.6)	4.54 (14.7)	0.98 (3.2)

Based on the estimations provided by its model, and the main objective of an EU action, **option 2.2.6** could be considered as an appropriate choice, which would ensure a high level of protection under normal market conditions while equally ensuring a sufficiently high level of protection in times of stress.

As shown in the table 21, the cost of funding implied by the choice of this option varies according to the lines of business covered and the desired proportion of Member States that would achieve the selected level of protection. In particular, selecting Option 2.2.6 would mean that, at EU level, a minimum harmonised target level of around **2.33%** of the Gross Direct Written Premiums would ensure that all Member States (i.e. MAX) could protect policyholders and beneficiaries for all business lines in 99% of the (yearly) default events if the probability of default is 0.1%.

These funds could be seen as additional premiums that policyholders are paying to insure themselves against the possibility that their insurance undertaking defaults. The payments provided by policyholders can be considered to be roughly equivalent to the expected value of the losses they would avoid in case their insurance undertaking defaults. This would represent a yearly cost increase for policyholders of about EUR 2.49 for a yearly premium of EUR 1,000.

The financial costs for the industry can be computed considering the Solvency II cost of capital of 5% (in accordance with the proposed revision of the cost-of-capital rate for the risk margin as part of this impact assessment). For an IGS with a level of funding of about 2.33% of annual premiums, this would translate into financial (capital) costs of about 0.12% of annual premiums.

However, the actual funding needs of Member States may vary and be lower than those estimates, depending on the specificities of national insolvency frameworks, the possibility to use alternative funding mechanisms and the use of certain resolution tools. These needs will also depend on the final funding design, i.e. ex ante funding, ex post funding or a combination of both. In particular, the choice of the funding structure may need to reflect that some insurance products have more limited payout and maturity profiles. In addition, the financial burden could be smoothened over a sufficiently long transition period in order to maintain an acceptable yearly impact. Therefore, while prefunding with a minimum harmonised target level may increase the trust of all stakeholders in the credibility of a framework based on the home country principle, the design of the funding model could ultimately contribute to ensure the overall balance of the proposal.

3.2.6. Eligible claimants

According to EIOPA, 13 of the existing national IGSs provide protection to natural persons solely, 11 schemes extend coverage to natural and micro- and small-sized entities and two IGSs cover all natural and legal persons.

Covering all natural and legal persons might be excessively expensive. It may also not be fully justified because of the main objective of IGS, i.e. the protection of retail customers. In order to reduce funding needs, eligibility could be restricted to those claimants who meet certain criteria.

One possibility is to restrict IGS protection to natural persons only (i.e. policyholders, beneficiaries and third parties). However, this might raise concerns about inadequate protection for legal persons that resemble retail customers.

Another possibility might be to extend IGS protection to include also selected legal persons that resemble retail consumers, such as micro-sized entities. The meaning of micro-sized entities would be the one defined by the European Commission[152].

This option would exclude SMEs and large corporate policyholders from IGS protection. SMEs and large corporates are better equipped to make an informed judgement on the financial soundness of insurers and have a greater capacity to manage their risks, for example by diversifying their risks by purchasing policies with various insurance companies or seek other forms of protection. EIOPA specifies however that, in order to avoid social hardship, the related beneficiaries or third parties – understood to be natural persons or micro-sized entities – of a company that is not protected by an IGS should still have the right to claim for compensation to the IGS, for example in case of a work accident, professional liability insurance or an airplane crash.

The Commission services believe that based on EIOPA's analysis and advice the main objective of an EU action would adequately be met by **covering natural persons and micro-sized entities**. As the above estimations of funding needs are considering all types of policyholders[153], the preferred scope will also contribute to constrain the possible costs of an EU action and would possibly reduce the final funding needs of Member States.

[152] See Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

[153] For reasons of data availability, it is not possible to consider the different types of policyholders in the model developed to estimate the funding needs of an IGS.

4. ARE THERE ALTERNATIVE TO SPECIFIC EU ACTION ON IGS?

The importance of introducing an IGS depends on the risk of failure of insurance companies and the potential impact that such failures could have on policyholders. This raises the question as to what alternative protection mechanisms are available at national or at European level to mitigate the risk of insurance failure or to reduce the losses for policyholders if the risk materialises.

- *Prudential regulation and risk management*: Solvency II provides for a risk-based, economic approach to solvency. It requires insurance and reinsurance undertakings to hold sufficient capital to cover their obligations over a 1-year time horizon subject to a 99.5% VaR confidence level. This should ensure that, during any given year, the failure of an insurer occurs no more often than once in every 200 cases. Effective risk management and comprehensive governance structures are cornerstones of the solvency system, in addition to capital requirements and appropriate supervisory powers of varying degrees of intensity. In spite of the many safeguards contained in Solvency II, it cannot ensure a zero-failure regime. It is widely acknowledged that it would be too costly to set solvency requirements at a level that would be sufficient to absorb all unexpected losses.
- *Preferential treatment of policyholders in winding-up proceedings*: in the event of the winding up of an insurance undertaking, the current EU winding-up legislation offers Member States a choice between two alternatives in national law for giving priority treatment to insurance claims over other creditors of the insurer in liquidation[154]. However, reliance on winding-up proceedings may not be workable in practice, and experience has demonstrated this. Firstly, there may not be a sufficient amount of assets for the protection of policyholders, in particular when the insolvency would occur during a financial crisis. In the absence of loss mutualisation, this gives rise to uncertainty over whether policyholders can in all cases be compensated. Secondly, winding-up proceedings of insurance undertakings are not only complex but also expensive and time-consuming. This may create serious social hardship linked to liquidity shortages for policyholders with outstanding claims at the time of insolvency, if their claims cannot be satisfied within a reasonable period of time. Furthermore, in order to facilitate claim handling for policyholders, beneficiaries and third parties that reside in other Member States than that of the insurer that can no longer cover claims, a cross-border mechanism between IGS is needed. Dealing with insolvency procedures and insolvency administrators in other Member States has proven to be a challenging task for the envisaged eligible claimants.

  However, the choice made by certain national systems to give priority treatment to insurance claims over other creditors of an insurer in liquidation as well as the possibility for the IGS to benefit from a priority on the insolvency estate could influence the design of the national IGS in particular its funding structure, insofar they are considered as complementing the IGS framework in terms of policyholder protection.
- *Case-by-case government intervention*: case-by-case solutions such as ex-post government interventions, while by their nature flexible, also have serious drawbacks. Unequal interventions may raise concerns regarding fairness and transparency, as relevant decisions are made on an ad-hoc basis rather than according to a set of pre-designed rules. In addition, case-by-case intervention may be perceived as privileging larger undertakings thereby incentivising risk and creating moral hazard through the

[154] Article 275 of Solvency II.

assurance of safety nets for which others have to pay. Ad-hoc interventions may create uncertainty both for policyholders and, depending on their financing, for taxpayers and the industry.

- *Additional information and enhanced transparency*: Approaches which enhance transparency and information requirements seek to strengthen policyholders' capacity to choose the most appropriate insurance product for themselves. These approaches rely on the assumption that relevant information is properly understood and incorporated in the decision-making process of policyholders. Particularly in Member States where the policies of domestic and incoming insurers are subject to different levels of IGS protection, enhanced information may in principle alleviate concerns about consumer protection within Member States. However, it is highly unlikely that policyholders are capable of understanding and processing all relevant information, particularly with regard to cross-border insurance business. Moreover, additional information does not alone address the issue of the differential consumer protection between different Member States and the fragmented IGS landscape within the EU as such, i.e. the lack of IGS in many Member States.

5. CONCLUSIONS

The present annex provides evidence supporting the need for a legally binding EU solution on IGS protection based on minimum harmonization in order to ensure that IGS exist in all Member States and that they comply with a minimum set of design features. Based on the analysis contained in this Annex, the Commission services' preliminary preferences with regard to the IGS design features would be the following:

- **Level of harmonisation**: the Commission services would recommend introducing an IGS in all Member States, subject to minimum design features, because this is consistent with the existing national micro-prudential supervisory framework;
- **Role and function**: the Commission services believe that the role of an IGS should be that of solely acting as a last resort protection mechanism in order to avoid as much as possible moral hazard problems in the behaviour of insurance undertakings and possible state aid issues. Portfolio transfers where they are reasonably practicable and justified in terms of costs and benefits would be the preferable solution. However, when all other means are exhausted, IGS should compensate losses of policyholders and beneficiaries;
- **Geographical scope**: in the Commission services' view, the home state principle would be the preferable policy option, especially because of its consistency with the existing supervisory framework;
- **Eligible policies**: the Commission services would recommend to cover all life policies and selected non-life policies as this strikes the right balance between ensuring a sufficiently large and solid protection of consumers on the one hand, and limiting costs on the other hand;
- **Eligible claimants**: the Commission services believe that covering natural persons and selected legal persons (i.e. micro-sized entities) would be the best way to strike the right balance between ensuring a sufficiently large and solid protection for consumers on the one hand, and cost efficiency on the other hand;
- **Coverage level**: the Commission services would prefer to cover all life policies at a minimum absolute level of 100,000 EUR combined with a harmonised coverage share of 85% of claims resulting from eligible life and non-life policies.
- **Timing of funding**: the Commission services would prefer ex-ante funding which could be complemented by ex-post funding where necessary. This would ensure the

immediate availability of funds while limiting costs to industry and consumers and foster the level-playing-field;

- **Nature of contributions**: the Commission services believe that, for the ex ante part of the funding design, risk-based contributions would ensure an adequate structure of incentives, address potential moral hazard and ensure the fairness of levies on the industry. The level of the contributions would be left to the discretion of the Member States, considering a harmonised target level and an adequate transition period.
- **Target level**: Conscious of the balance between a high degree of policyholders' protection and the need to maintain costs for the industry and the society at an acceptable level, the Commission services would suggest setting a harmonised target level for both life and non-life businesses between 2.30% and 2.50% of the GDWP, depending on the scope of eligible policies, to be reached over a transition period of 10 years.

ANNEX 6: ANALYTICAL METHODS

We refer to the Joint Research Centre (JRC)'s technical report entitled "Insurance Guarantee Schemes: quantitative impact of different policy options"[155]. In this report, and at the request of DG FISMA, the JRC assesses the size of losses due to defaults in the EU insurance sector and estimates the amount of funding needs for each IGS.

[155] https://publications.jrc.ec.europa.eu/repository/handle/JRC124577

ANNEX 7: IMPACT ASSESSMENT OF TECHNICAL TOPICS THAT WERE NOT EXPLICITLY COVERED BY THE MAIN BODY OF THE IMPACT ASSESSMENT

Some technical topics have not been explicitly covered by the main body of the impact assessment. For this reason, those topics are subject to a dedicated impact assessment in this annex, leveraging on EIOPA's own impact assessment.

1. SAFEGUARDS IN THE USE OF INTERNAL MODELS

The supervision of internal models has not been explicitly covered as part of the problem on the *deficiencies in the supervision of insurance companies and groups* (fourth problem of the main body of the impact assessment).

Solvency II allows that supervisors approve the use of a partial or full internal model for the calculation of the solvency capital requirement. At the end of 2019, insurance companies using a partial or full internal model made up around 32% of the EEA insurance market in terms of insurers' liabilities towards policyholders[156]. Insurers that use an internal model must ensure that it captures all of the material risks to which the insurer is exposed. In that context, Solvency II prohibits that Member States and supervisory authorities prescribe methods for the calibration of internal models.

1.1. Problem definition

While the methodological freedom for internal model calibration allows to capture very specific risks and to reflect the particular situation of a company, it also implies that insurers can use very different methods the outcomes of which are difficult to compare. Due to this lack of comparability, the supervision of insurance companies that use an internal model is more demanding as the "[interpretation] of [internal model] figures depends heavily on [supervisory authorities'] knowledge of the internal models they supervise as well as the risk profile of the supervised undertakings or groups"[157]. Likewise, the comparison of prudential disclosures by insurers is more difficult where at least one insurer uses an internal model than if this was not the case. Against this background, EIOPA conducts regular comparative studies, because it is of the view " that national supervisors […] need tools, such as European comparative studies, to be provided with a necessary overview of model calibrations"[158].

Furthermore, there are 63 insurers and nine insurance groups that used internal models at the end of 2019 and also modelled the impact of spread scenarios on the volatility adjustment ("dynamic volatility adjustment")[159]. In such cases, the volatility adjustment will increase in scenarios of spread increase and thereby compensate for some or all of the solvency capital requirement that can be attributed to spread risk. Section 2.2 describes that the current volatility adjustment can lead to "overshooting" of spread widening in the determination of prudential capital resources. In fact, three insurers using an internal model reported observations of overshooting of the volatility adjustment to EIOPA[160]. Internal models that integrate a dynamic volatility adjustment could lead to an extension of the overshooting effects from the prudential capital resources to the capital requirements calculation.

[156]EIOPA: *Report on long-term guarantees measures and measures on equity risk 2020* (link), page 18
[157] See EIOPA, *Opinion on the 2020 review of Solvency II – Analysis*, December 2020 (link), paragraph 7.66
[158] See EIOPA: *Market and Credit Risk Comparative Study YE2019* (link), page 4
[159]See EIOPA, *Opinion on the 2020 review of Solvency II – Analysis*, December 2020 (link), paragraphs 2.347 and 2.348
[160] See EIOPA, *Opinion on the 2020 review of Solvency II – Analysis*, December 2020 (link), paragraph 2.363

1.2. What are the available policy options?

Option label	Option description
Option 1: Do nothing on internal model safeguards	This is the baseline. Do not require the calculation of standard formula results and keep case-by-case approach as regards the integration of the dynamic volatility adjustment in internal models
Option 2: Improve supervisors' access to standardised information and impose safeguards in the modelling of the volatility adjustment	Under this option, users of internal models would be required to also report their capital requirements calculated with the standard formula to supervisors. In addition, Option 2 would impose safeguards where an internal model integrated the dynamic volatility adjustment. This is in line with EIOPA's advice.
Option 3: Limit the overall impact of internal models	Require a disclosure of the SCR calculated with the standard formula and prohibit the use of the dynamic volatility adjustment

1.3. What are the impacts of the options and how do they compare?

Only a high-level impact assessment of the options is provided, as EIOPA assessed the options in detail[161].

1.3.1. Option 1: Do nothing on internal model safeguards

This is the baseline scenario in relation to internal models. Under Option 1, no change would be made to the prudential rules as regards internal models. Therefore, Option 1 would not address the issue of a lack of comparability of SCR figures and a potential overshooting from the volatility adjustment in the SCR calculation. On the one hand, users of internal models have argued for maintaining the current framework in order to allow insurers to align internal models as closely as possibly with their idiosyncratic risks. On the other hand, several supervisory authorities, EIOPA and the ESRB have lamented the lack of comparability of results from internal models.

1.3.2. Option 2: Improve supervisors' access to standardised information and impose safeguards in the modelling of the volatility adjustment

Under option 2, insurance companies that use an internal model for the calculation of capital requirements would be required to calculate, in addition, the capital requirements with the standard formula and report the outcome to supervisors. Furthermore, safeguards would be put in place where an internal model integrated the dynamic volatility adjustment. The safeguards would aim to avoid amplification of overshooting from the volatility adjustment in capital requirement calculations.

Benefits

Option 2 would provide supervisors with more comparable data thanks to the standard formula calculation, which provides a uniform reference. Supervisors could check the plausibility of the internal model against the standard formula calculation and they could compare companies better against their peers. Furthermore, the option would also establish a common safeguard against amplification of a possible overshooting of the volatility adjustment and thereby avoid a reduction of capital requirements that is not commensurate

[161] See EIOPA, *Opinion on the 2020 review of Solvency II – Background impact assessment*, December 2020 (link), sections 2.4 and 8

with the risks. Option 2 would therefore enhance the **quality and the consistency of insurance supervision**.

Option 2 would also better **address the potential build-up of systemic risk** in the insurance sector. Thanks to the uniform reference provided by the standard formula calculation, supervisors would also be able to form a better view the sector as a whole and detect more effectively the potential build-up of systemic risks.

Costs

Option 2 would result in hard to estimate one-off and on-going **implementation cost**. Insurers using an internal model would have to put in place the processes for the calculation of the standard formula and, additionally for insurers using the dynamic volatility adjustment, the additional calculations required under the new safeguard. Given the large degree of flexibility for internal models and their potentially large impact on insurers' financial position, the implementation cost seems acceptable.

Option 2 would lead to a limited increase in **capital requirements**. While the additional calculation of the standard formula would not affect the level of capital requirements, EIOPA estimates that the safeguard would increase capital requirements of companies using the dynamic volatility adjustment by around € 5 billion[162].

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would achieve improved safeguards in the use of internal models while causing reasonable costs. In particular, the option would not imply any material cost with respect to the strategic objectives for this review.

Winners and losers: Supervisors and policyholders are winners under option 2. Supervisors would have access to more comparable information and be better able to detect company-specific and systemic risks. This would also benefit the protection of policyholders. Both would benefit from safeguards that avoid an amplification of the overshooting of the volatility adjustment. To the contrary, insurers would be losers under option 2. The safeguards on the dynamic volatility adjustment would result in limited increases of capital requirements. Additionally, those safeguards and the standard formula calculation for reporting to supervisors would result in implementation cost.

Stakeholder views: During the public consultation, half of the respondents from the category of public authorities expressed support for a requirement on internal model insurers to report to supervisors standard formula calculations. Only around 10% of the respondents from the insurance industry supported such a requirement.

1.3.3. Option 3

Under Option 3, insurers which use an internal model would not only be required to report standard formula results to the supervisors, but also to disclose such information to the general public. This would be in line with the ESRB's recommendation. In addition, in view of the technical deficiencies of applying the dynamic volatility adjustment in capital requirements, Option 3 would imply prohibiting such use.

Benefits

Similar as Option 2, Option 3 benefits the **quality, consistency and coordination of insurance supervision** by a requiring a disclosure of standard formula calculation. Furthermore, the uniform prohibition of the dynamic volatility adjustment would remove any

[162] See EIOPA, *Opinion on the 2020 review of Solvency II – Background impact assessment*, December 2020 (link), page 53

possibility of an amplification of overcompensation from the volatility adjustment in the SCR and not allow for diverging supervisory practices.

Similar as Option 2, Option 3 would address the potential build-up of **systemic risk** by a requiring a disclosure of standard formula calculation. Furthermore, the uniform prohibition of the dynamic volatility adjustment would remove any possibility for the build-up of systemic risk through an amplification of overcompensation from the volatility adjustment in the SCR.

Costs

By imposing the disclosure of standard formula calculations, Option 3 might result in pressure on insurance companies to base their decisions to a lesser degree on the outcome of the internal model and more on the standard formula calculation[163]. That pressure may lead to a cost on **risk-sensitivity** as internal models are intended to capture better than the standard formula the particular risks that an insurer is exposed to.

While the impact on **capital requirements** of the dynamic volatility adjustment itself is not disclosed, insurance company's disclosures on the impact of the volatility adjustment can be compared. The removal of the volatility adjustment would, at the end of 2019, have decreased solvency ratios by 25% on average over all EEA companies applying the volatility adjustment[164]. The average decrease in solvency ratios for the sub-sample of companies applying the dynamic volatility adjustment would have been 47%[165]. The much higher impact in that sub-sample can be assumed to be largely driven by the reduction of the solvency capital requirements caused by the dynamic volatility adjustment. Option 3 can therefore be assumed to increase significantly the capital requirements for companies currently applying the volatility adjustment.

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would achieve the most effective safeguards in the use of internal models. However, the option would result in large costs with respect to both capital requirements and strategic objectives. In particular, the option might be harmful for risk-sensitivity which was one of the main objectives of the introduction of internal models.

Winners and losers: Neither supervisors nor policyholders are clear winners or losers under option 3. While both would have access to comparable standard formula calculations, the option may also incentivise decision-making on the side of the insurer that is not fully reflective of the company's risks. Insurers would be losers in two ways under Option 3. First, the removal of the dynamic volatility adjustment would result in significantly higher increases of capital requirements than Option 2. Second, the disclosure of standard formula calculations would result in pressure to manage the company with respect to those results. That would undermine the benefits of having developed costly internal models.

Stakeholder views: During the Commission's public consultation, around 59% of the respondents from the insurance industry and half of the respondents from the category of public authorities opposed a requirement on internal model insurers to calculate the standard formula. None of the respondents from that category supported a requirement to publicly disclose such calculations. However, supervisory authorities approved EIOPA's proposal to require such disclosure. This proposal is also supported by the ESRB. Consultation responses from the category NGOs, consumers and citizen expressed either supported a requirement for

[163] This might undermine the so called "use test" required under Article 120 of the Solvency II Directive.
[164] EIOPA, "*Report on long-term guarantees measures and measures on equity risk 2020*", December 2020 (link), p. 79
[165] Ibid., p. 88

public disclosure (60%) or indicated no opinion (40%). Safeguards as regards the dynamic volatility adjustment were supported by supervisory authorities via EIOPA's Board of Supervisors. Insurance companies that are using the dynamic volatility adjustment have expressed concerns on the complexity and the limitations on the alignment of the internal model with a company's specific circumstances.

1.3.4. Summary

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volatility	Proportionality	Supervision - protection against failures	Financial stability		
Option 1	0	0	0	0	0	0	**0**	**0**
Option 2	0	0	0	0	++	++	+++	++
Option 3	0	--	-	0	+	++	--	--

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	-	++	++
Option 3	---	+/-	+/-

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

Option 2 appears to be the most suitable option. While Option 3 would be the most effective in establishing safeguards in the use of internal models, the cost of those safeguards seems unreasonably high. Moreover, Option 2 would not result in any costs with respect to the specific objectives whereas Option 3 might undermine risk-sensitivity and therefore be incoherent with the principal objectives of internal models. Option 2 is therefore considered much more effective and coherent than Option 3. Finally, Option 2 is also preferred over the baseline Option 1 as it is effective without implying unreasonable cost.

2. REPORTING AND DISCLOSURE REQUIREMENTS

2.1. Background and problem definition

Rules governing improved reporting (to public authorities) and disclosure (to the public) of prudential information could be implicitly considered covered as part of the problem on the *deficiencies in the supervision of insurance companies and groups* (fourth problem of the main body of the impact assessment).

The reporting burden has been identified as an important issue for the insurance industry, which calls for an ambitious streamlining of the requirements and a significant relief in terms of data quantity and deadlines of submissions. Those concerns have been corroborated by the

conclusions of the Fitness check on supervisory reporting[166]. However, the supervision of a very sophisticated risk-based system of capital requirements as Solvency II requires frequent and extensive regular reports. Therefore, a material reduction in reporting requirements could jeopardize the quality of supervision, and supervisors may try to circumvent this limitation by imposing at national level more frequent ad-hoc reporting. Still, the reporting framework could better take into account the new category of "low-risk profile insurers" that would be introduced in order to address the problem of *insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs.*

In addition, the information disclosed to the public is very detailed and granular, but may not be fit for purpose. For financial experts (analysts, etc.) detailed and high-quality information is deemed crucial, but the current set of information is not necessarily always comparable between the largest insurers and insurance groups, notably because insurers do not necessarily disclose in the same manner their exposure to different risk drivers (lack of harmonisation of sensitivities of solvency ratios to different market drivers). For policyholders, information in SFCRs may not be easily understandable. According to the German insurance Association (GDV), in 2018, German SFCRs were downloaded on average 33 times per month during the first months following their publication[167].

Finally, while reporting and disclosure is an important source of information for stakeholders, there is no requirement at EU level ensuring the accuracy of the information provided, although 17 Member States impose at national level some audit requirements with different scopes (balance sheet only, balance sheet and capital requirements, etc.).

The review of the rules that govern the data collection to supervisory authorities is a key part of EIOPA's advice. However, EIOPA's work in this area goes beyond the sole review of the Solvency II Directive and the Delegated Regulation and encompasses:

1. Proposals to amend rules of the Solvency II Directive and Delegated Regulation governing the frequency and quality of reporting and the general structure and content of narrative reports (regular supervisory report to the NSA and SFCR that is publicly disclosed);
2. Review of Quantitative Reporting Templates (i.e. the templates of granular quantitative information that insurers should submit to public authorities). Those rules are laid down in implementing technical standards on reporting and disclosure and in parallel to the Solvency II Review. EIOPA intends to make proposals of amendments to those with the aims of i/ ensuring that the information requested is necessary, fit-for-purpose and up-to-date to support efficient supervision by public authorities, ii/ checking whether information that may be important for the supervisory review process is not missing and iii/ reviewing the scope of insurers that need to report certain data taking into account the extent of their exposures to certain risks (e.g. only insurers with exposures to derivatives above a certain threshold – to be defined by EIOPA – would be required to fill in the relevant reporting template on derivatives)
3. More forward-looking activities that go beyond Solvency II and aims at developing a reporting system that is more efficient by reducing the number of data requests and avoiding overlaps between reporting obligations of different existing frameworks.

This annex will discuss Point 1 only. Point 2 is a prerogative of EIOPA and will follow a parallel process to the review of the Solvency II Directive and Delegated Regulation. Finally, in relation to Point 3, and in line with the Digital Finance Strategy, the Commission services

[166] *Of all the sectors, insurers/re-insurers spent the greatest share of their one-off and ongoing-costs on supervisory reporting costs (respectively 38% and 36% on average), closely followed by financial markets (37% and 28%)*, page 205 of the Fitness Check of EU Supervisory Reporting Requirements, November 2019

[167] See https://www.gdv.de/resource/blob/51928/c30fa2bb32711d7edb699e5b163ebafb/reporting-2-0---eiopa-vorschlaege-mit-korrekturbedarf---download--en--data.pdf

intend to mandate EIOPA to further analyse the necessary legislative and regulatory amendments in order to clarify and facilitate the use of data already reported within other European reporting frameworks to competent authorities, both national and European ones. This would help avoid redundant reporting requirements for insurers. EIOPA identified two areas where the sharing of information between competent authorities should be prioritised: derivatives and collective investment undertakings[168]. In any case, further work is needed to eliminate duplications, inconsistencies, and to enhance the "re-use" of data requested in accordance with other frameworks, and/or collected by other authorities.

EIOPA's proposals in relation to Solvency II can be summarised as follows:

- Improve the quality of the information disclosed to the public: EIOPA puts forward a new structure for the SFCR, with a part addressed to policyholders (including simple, clear and meaningful information to non-expert readers), and another one, more detailed, addressed to financial market participants and other financial experts. The latter part includes the publication of some fundamental reporting templates, among which is the Solvency II balance sheet.
- Improve the reliability of the information submitted to supervisory authorities and disclosed to the public: EIOPA recommends introducing a new requirement to audit the Solvency II balance sheet in all Member States, for both individual insurers and insurance groups. However, in order to counterbalance the additional regulatory and compliance costs generated by this requirement, EIOPA also proposed an extension of two weeks of the deadline for the submission of the annual reporting package and an extension of four weeks for the publication of the SFCR.

[168] Collective investment undertakings means a UCITS as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council or an AIF as defined in point (a) of Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council.

2.2. What are the available policy options?

Option label	Option description
Option 1: Do nothing on reporting and disclosure	This is the baseline scenario in relation to reporting and disclosure
Option 2: Improve quality of reporting and disclosure but extend reporting deadlines	In line with EIOPA's advice, Option 2 would imply - improving accuracy of information provided by introducing an audit requirement of the Solvency II balance sheet; - alleviating some regulatory burden, by extending the deadline for annual reporting by two weeks and the deadline for disclosure by four weeks - improving the readability of the SFCR: split the report with one section targeting policyholders and another one for financial experts which should include, in addition to current requirements, sensitivity analyses for the largest insurers.
Option 3: Go further than EIOPA in order to reduce regulatory burden for low-risk profile insurers[169]	Same as in Option 2, but with the following proportionality measures: - the audit requirement would not apply for low-risk profile insurers; - the publication of a full SFCR by low-risk profile insurers would only be required every other three years (a simplified SFCR would only be required when the full report is not published)

Options discarded at an early stage

Similarly to the extension of annual reporting deadlines, the Commission services have considered extending reporting deadlines for quarterly reporting (currently set at five weeks following the end of the quarter). While this could in theory represent a material alleviation of regulatory burden to insurers, such an approach would however be in conflict with the reporting deadlines for statistical reporting to the European Central Bank (currently, five weeks as well), as laid down in its Regulation (EU) No 1374/2014. Recital 10 of this Regulation even indicates that the European Central Bank will consider reducing further quarterly reporting deadlines down to four weeks. Therefore, any extension of reporting deadlines in Solvency II would prove to be ineffective if the same information is subject to shorter deadlines in accordance with the ECB Regulation and has to be submitted to public authorities.

In addition, Solvency II provides that public authorities may waive or reduce the scope of quarterly reporting for up to 20% of each national market. However, there is no obligation to implement such waivers or limitations of quarterly reporting requirements. EIOPA has assessed whether there is a need to impose for each authority to waive or limit reporting requirements for at least 5% of each national market. However, EIOPA's impact assessment concludes that the costs and risks associated with such waivers off-set the potential benefits in terms of reduction of reporting requirements. The Commission services agree with EIOPA's assessment, and therefore have not re-assessed this possibility. In addition to the arguments put forward by EIOPA in its impact assessment, such an approach could once more be in conflict with reporting requirements imposed by the ECB Regulation (EU) No

[169] This concept is further explained in Sub-sections 6.3.1 and 6.3.2 of the Impact Assessment

1374/2014. Indeed, according to Recital 10, the ECB will assess the merits of increasing the coverage of quarterly reporting from 80% to 95%. If such a change were to be implemented, the maximum scope of exemptions and limitations would be 5% of each national market, which would contradict any attempt in the context of Solvency II to introduce mandatory waivers / limitations for at least 5% of national markets[170].

Note however that in the context of the problem of *insufficient proportionality of the current prudential rules generating unnecessary administrative and compliance costs*, the preferred option is Option 3 ("*Give priority to enhancing the proportionality principle within Solvency II and make a lower change to the exclusion thresholds*"). This Option introduces a concept of low-risk profile insurers which would benefit from the automatic application of proportionate Solvency II rules. In practice, in relation to the existing possibility to waive or limit quarterly reporting requirements, priority would have to be given to "low-risk profile insurers" when public authorities decide to grant exemptions or limitations of quarterly reporting.

2.3. What are the impacts of the options and how do they compare?

As the impact assessment of Option 2 largely relies on EIOPA's detailed impact assessment, for further details, we refer to EIOPA's Background Document – Analysis (Section 7) and Background Document - Impact Assessment (Section 7). Only a summary of EIOPA's impact assessment (notably Option 2) is provided below.

2.3.1. Option 1 – Do nothing on reporting and disclosure

Under the baseline scenario, no change would be made to the prudential rules as regards reporting and disclosure. This implies that no alleviation of reporting requirement would be introduced, to the detriment of insurers. Similarly, the SFCR would remain too technical for policyholders, and there would be no obligation to ensure that the information provided is reliable.

2.3.2. Option 2 - Improve quality of reporting and disclosure but extend reporting deadlines

Under this option, and in line with EIOPA's proposals, the following actions would be implemented:

- Extension of the deadline for annual reporting by two weeks and for disclosure by four weeks;
- New structure of the SFCR, with two separated parts: A high-level brief section for policyholders, and a more detailed and granular section for other (technical) stakeholders; this technical part would standardized sensitivity analyses for the largest insurers;
- New auditing requirement of the balance sheet for all insurance companies and groups.

Benefits

Under Option 2, the changes proposed by EIOPA would ensure that the "reporting package" remains fit for purpose and the **proportionality principle** is better implemented in the

[170] There would be no conflict if it were possible in each Member State to exempt exactly 5% of a national market (not more, not less), but it is quite unlikely that the market shares are such that an exact figure of 5% can be achieved.

reporting framework. Therefore, supervisors would collect the necessary data and insurers would benefit from the extension of the annual reporting deadlines. The readability of prudential information that is publicly disclosed would be materially improved, as policyholders would benefit from the simpler structure of the SFCR. For other stakeholders, the introduction of standardised sensitivity analyses for the largest insurers that are relevant for financial stability purposes would improve the comparability of insurers' risk exposures to other market participants (i.e. insurers would have to disclose how their solvency position is affected by changes in certain market variables, e.g. equity markets, interest rates, etc.). The accuracy and reliability of prudential information would be improved thanks to the auditing requirement of the Solvency II balance sheet. Therefore, the overall quality of the information provided to the public would be improved.

In summary, reporting and disclosure requirements would be amended so that they reduce undue regulatory burden (extension of reporting deadlines), they are proportionate to the risk of insurers (additional information is only required for the insurers that are relevant for financial stability purposes) and they are more transparent towards the public.

The enhanced reliability of prudential information implies that Option 2 would also enhance the **quality of insurance supervision**, and **would improve the policyholder protection**. It would also **enhance the level-playing field** by ensuring that audit requirements apply to all insurers wherever they are located. The general improvement of the reporting data, of the transparency to the public (which can improve market discipline) and of the insurance supervision more broadly, could reduce the potential build-up of systemic risks in the insurance sector, with **positive effects on financial stability**.

Costs

Option 2 would generate additional implementation/compliance costs due to the new requirement on auditing of the balance sheet. According to EIOPA's advice, the expected cost would be in a range between EUR 5,000 and 600,000, with a median value of EUR 50,500. However, it should be noted that such requirements are already implemented in several EU Member States, following an EIOPA's statement[171] issued in 2015, because national legislations established an auditing requirement for the balance sheet or an even broader scope (key elements like balance sheet, capital requirements, eligible own funds, or even the whole SFCR). Currently, 13 Member States impose audit requirements that go broader than the Solvency II balance sheet, while 3 EEA Member States (Germany, Denmark and Liechtenstein) only require the auditing of the balance sheet. Therefore, implementation costs would only apply to insurers based in the nine Member States, which currently do not impose any audit requirement[172]. Indeed, according a recent survey from EIOPA[173], 73% of companies indicated that they were already auditing the balance sheet, and 84% of them, that the audit requirements were broader than the Solvency II balance sheet.

Option 2 would also generate some minimal implementation costs in relation to the disclosure of information on sensitivities, following a standardised approach. However, this requirement would apply only to insurers that are relevant from a financial stability perspective. EIOPA's proposed approach follows the best practices observed in the market and in fact reflects what the largest companies were already disclosing, although with some differences between them, which was preventing comparison. As such, EIOPA concludes that this would not generate material compliance costs, while it would contribute to improving transparency and comparability between the largest insurers.

[171] *Need for high quality public disclosure: Solvency II's report on solvency and financial condition and the potential role of external audit*, EIOPA BoS 29 June 2015

[172] Slovakia, France, Hungary, Latvia, Finland, Czech Republic, Estonia, Lithuania, and Luxembourg.

[173] See page 30 of EIOPA's Background Impact Assessment

Overall assessment

Effectiveness, efficiency and coherence: Option 2 would be effective, because it would address the weaknesses identified on reporting and disclosure by EIOPA, with positive impact on quality of supervision and – to a lesser extent – financial stability. However, the very significant impact of the auditing requirement in those Member States which impose no requirement could outweigh any reduction in the reporting burden for the smaller and less risky insurers. It would also be coherent with the Solvency II objectives of policyholder protection and financial stability.

Winners and losers: As data quality would be improved, supervisors and policyholders are winners under this option. Main losers would be the insurers based in Member States, where no auditing requirement is implemented. On the contrary, since in many Member States such a requirement is already in place, Option 2 would address level-playing field issues, setting harmonized rules in Europe.

Stakeholder views: During EIOPA's public consultations, insurance stakeholders expressed reluctance to any new auditing requirement due to high compliance cost and the limited benefit that it could bring in their view. Additionally, some stakeholders claim that this is redundant with the general mandate of supervisory authorities to ensure compliance with prudential rules, including in relation to reporting and disclosure.

2.3.3. Option 3 – Go further than EIOPA in order to reduce regulatory burden for low-risk profile insurers

Under Option 3, the same changes would be implemented as in Option 2, with the two following adaptations in order to enhance proportionality of the framework:

- Reduction of the frequency of publication of the full SFCR for low-risk profile insurers: instead of annual publication, the publication would be triennial, provided that low-risk profile insurers disclose a simplified SFCR during the years when the full report is not published. This simplified report would contain the section addressed to policyholders and a simplified part addressed to the rest of stakeholders, consisting of the quantitative reporting templates, without additional narrative explanations;
- Exemption from the auditing requirement for low-risk profile insurers, as the additional compliance costs could outweigh the added value provided by such requirement.

Benefits

Like in Option 2, the auditing requirement would improve the accuracy and reliability of the Solvency II balance sheet for the insurers concerned, with improved quality of information submitted to supervisory authorities and the public. The exemption of the auditing requirement for low-risk profile insurers would avoid generating additional compliance costs for the insurers concerned.

Like in Option 2, the dual structure of the SFCR and the inclusion of sensitivity analyses for the largest insurers would improve the quality of information provided to stakeholders and foster comparability between insurers, with potential positive effects on market discipline and financial stability.

Additionally, the reduction of the frequency of the full SFCR would decrease compliance costs related to disclosure requirements for low-risk profile insurers. Transparency towards policyholders would still be ensured as the part dedicated to them would be published on a yearly basis. Similarly, the quantitative reporting templates (which are also submitted to supervisors) would still be disclosed, which ensures that stakeholders receive a minimum set

of quantitative information from all insurers. Still, the reduced frequency of the publication of the narrative part targeted to specialised stakeholders would materially reduce the size of the SFCR and therefore reduce compliance costs for the companies concerned.

Therefore, Option 3 would warrant high **quality of supervisory data** (like in Option 2) while making more reporting and disclosure requirements **more proportionate**. It would avoid that low-risk profile insurers be required to comply with disproportionate disclosure and auditing requirements.

Option 3, although having a **positive impact on financial stability** as Option 2, would not be as effective as Option 2 in preventing the potential build-up of systemic risks stemming from low-risk profile insurers. However, this risk does not seem to be material when considering small sized insures with very limited cross border business.

Cost

The compliance and **implementation costs** would be similar as in Option 2, but they would still be lower under Option 3, in view of the waiver of audit requirement for low-risk profile insurers and the more proportionate disclosure requirements.

One could consider that the waiver of audit requirement be detrimental to the policyholders concerned, as they would benefit from a lower level of protection than other policyholders (information may be less reliable). On the other hand, the exemption of audit requirement would apply to "low-risk profile insurers", characterised by more simple products and business activities. Therefore, the risk of inappropriate and unreliable balance sheet is expected to be low.

Overall assessment

Effectiveness, efficiency and coherence: Option 3 would be the effective in addressing the weaknesses of the reporting and disclosure framework identified by EIOPA, while avoiding disproportionate costs for the smallest and least complex insurers. Furthermore, it would allow reducing compliance costs of supervisory reporting for smaller insurers. However, it would be less effective than in Option 2 in ensuring the reliability of the prudential data submitted by insurers (due to the reduced scope of audit requirement). Option 3 would be the most consistent with the Better Regulation agenda of reducing undue compliance costs for SMEs.

Winners and losers: In general, like in Option 2, policyholders and supervisors would be winners. In addition, small and less complex insurers would also benefit from Option 3, due to the lower frequency of publication of full SFCR and the absence of audit requirement. On the contrary, the benefit of Option 3 for policyholders of those insurers would be lower than in Option 2 as they would not benefit from the same level of reliability of information disclosed as other insurers. Similarly, supervisors of those insurers would not have the assurance of a reliable Solvency II balance sheet. The "streamlined SFCR" (when the full SFCR is not published) would provide less information than the full SFCR and as such would have a negative impact on the granularity of information provided to specialised stakeholders.

Stakeholder views: Option 3 would address some of the concerns from industry on the disproportionate costs of disclosure requirements and the auditing requirement recommended by EIOPA. In particular, in the context of the Commission's public consultation, the reduced frequency of the SFCR for low-risk insurers was explicitly mentioned by some insurance associations.

2.3.4. Summary

Option 2 is probably the most effective in improving the quality and reliability of prudential information reported and disclosed with positive effects on the level-playing field and financial stability. However, Option 3 appears to be more cost effective by ensuring that the above mentioned benefits are commensurate to the additional costs that they generate (in particular for low-risk profile insurers). Therefore, Option 3 is more cost-effective. Taking into account the impact on insurers and policyholders, Option 3 appears to be overall the most suitable option, as it would permit to ensure that the reporting and disclosure framework remains fit for purpose, of high quality and provides accurate information. Therefore, it ensures a high level of policyholder protection and transparency in Europe while avoiding disproportionate costs for low-risk profile insurers.

Therefore, the preferred Option is Option 3 ("Go further than EIOPA in order to reduce regulatory burden for low-risk profile insurers").

	Effectiveness						Efficiency *(Cost-effectiveness)*	Coherence
	LT green financing	Risk sensitivity	Volati-lity	Propor-tionality	Supervision - protection against failures	Financial stability		
Option 1	0	0	0	0	0	0	**0**	**0**
Option 2	0	0	0	++	+++	++	**++**	**+**
Option 3	0	0	0	+++	++	+	+++	++

	Summary of winners and losers		
	Insurers	Policyholders	Supervisory authorities
Option 1	**0**	**0**	**0**
Option 2	**--**	**+++**	**++**
Option 3	-	++	+

Legend: **+++** = Very positive **++** = Positive **+** = Slightly positive **+/-** = Mixed effect **0** = no effect **-** = Slightly negative **--** = Negative **---** = very negative

ANNEX 8: "ZOOMING" ON SOME ISSUES COVERED IN THE IMPACT ASSESSMENT

The aim of this annex is to provide further technical details on some elements discussed in the impact assessment. It allows "zooming" on some technical issues discussed in the impact assessment.

1. STRENGTHENING "PILLAR 2" REQUIREMENTS IN RELATION TO CLIMATE CHANGE AND SUSTAINABILITY RISKS

In order to address the problem of *limited incentives for insurers to contribute to the long-term financing and the greening of the European economy*, Option 4 – "Strengthen "Pillar 2" requirements in relation to climate change and sustainability risks" has been retained as part of the overall package of "preferred options" for the impact assessment. The aim of this section is to further clarify what is embedded within this option.

It has to be noted that several changes to Solvency II rules concerning sustainability risks have already been made using existing empowerments for delegated acts prior to this initiative. Following advice from EIOPA, Delegated Regulation (EU) 2021/1256[174] clarifies the obligations of insurance undertakings under Solvency II with respect to sustainability risks. For that purpose, following provisions were introduced:

- A definition of sustainability risks in the context of prudential rules for insurance companies;
- A requirement to take into account sustainability risks in risk management;
- An assignment of responsibilities related to sustainability risks to relevant key functions of insurance companies;
- A requirement for a stewardship approach as part of the rules on investments;
- A clarification of the relevance of sustainability risks in the remuneration policies of insurers.

However, this initiative was restricted by the scope of the current empowerments for delegated acts. Notably, there are no empowerments that would allow supplementing the rules on insurers' own risk and solvency assessments (ORSAs). Solvency II requires such regular assessments by insurers in order to (i) quantify their overall solvency needs with a view to their specific risk profile, (ii) verify continuous compliance with quantitative requirements and (iii) identify deviations of the company's risk profile from assumptions underlying the calculation of capital requirements. The ORSA therefore serves as important complement to the quantitative rules of "pillar 1". Outcomes of the assessment must be provided to supervisory authorities. Following its advice in advance of the adoption of Delegated Regulation (EU) 2021/1256, EIOPA also issued an opinion on sustainability in Solvency II in September 2019[175]. EIOPA identified the ORSA as a suitable instrument for insurers to manage environmental and climate risks and for supervisors to monitor those risks.

While capital requirements are usually quantified by determining the value-at-risk over a one year time horizon and with a confidence level of 99.5%, environmental and climate risks will typically materialise over a longer time horizon. Time horizons of significantly more than one year are common practice for the own risk and solvency assessments by insurers.

[174] Commission Delegated Regulation (EU) 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings (OJ L 277, 2.8.2021, p. 14)

[175] EIOPA, "*Opinion on Sustainability within Solvency II*", December 2020 (link)

Furthermore, the probability distributions of climate change-related risks are difficult to forecast. Scenario analysis is a widely-used tool to assess the vulnerability to risks that are difficult or not (yet) quantifiable by risk measures that rely on forecasted probability distributions. To strengthen insurers' management of environmental and climate risks and to address potential shortcomings with respect to such risks in quantitative prudential rules, this initiative will amend the rules on own risk and solvency assessments by a requirement on insurers to regularly assess the impact of longer-term horizon scenarios of climate change. Current rules on the ORSA underline that the assessment should be proportionate to the nature scale and complexity of the risks inherent in the business model of the company. This principle should also apply to the new element of climate change scenario analysis and in relation to the company's exposure to climate change-related risks.

In addition to strengthening the ORSA, the above mentioned opinion by EIOPA identifies insurers' use of data as an important area in the management of sustainability risks. Insurers often use data from past events to inform predictions on risks materialising in the future. Data from past events may in particular not sufficiently capture the trends caused by climate change. Where an insurer relies too heavily on such data, the company's best estimates for obligations to policyholders or its internal model, where applied, may underestimate obligations or relevant risks. This initiative will therefore introduce obligations on insurers to put in place internal procedures to avoid overreliance on data from past events with respect to climate change-related risks.

In addition to the points described above, further work on capital requirements can be envisaged. Option 5 – "Strengthen "Pillar 2" requirements and incorporate climate change and sustainability risks in quantitative rules" has been discarded because of the absence of its deviation from a risk-based approach and the resulting potentially detrimental impact on policyholder protection. However, evidence on the riskiness of sustainable investments can be expected to become available as EU actions on sustainable finance and the European Green Deal will be implemented. New evidence may allow the calibration of risk-based changes to capital requirements either for sustainable ("green") or environmentally harmful ("brown") investments.

Climate change is also widely assumed to have an impact on the frequency and severity of natural catastrophes. Insurers are exposed to natural catastrophes notably through their obligations to policyholders and beneficiaries, which usually stem from annual contracts. Insurers are in most cases able to react to changes in their vulnerability to natural catastrophe risks and adjust contractual conditions or premium levels regularly. However, climate change-induced trends in the frequency and/or severity of natural catastrophes may warrant changes to capital requirements for the natural catastrophe risk in the medium or long-term and possibly regularly thereafter. In addition to affecting the types of natural catastrophes more common in a given region, climate change may also expose geographical regions to entirely new types of climate disasters. For instance, global warming may cause droughts and wildfires to become common phenomena in regions that did not experience such events in the past. These two types of risks are currently not explicitly covered as catastrophe risks in the Solvency II standard formula because of their limited relevance for EU insurers at this stage. However, EU insurers may become more exposed to such or other types of natural disasters in the future and that may warrant amending the standard formula accordingly.

Against this background, this initiative will set out following mandates to EIOPA:

(i) Review, on an on-going basis, new evidence on sustainable investments and environmentally harmful investments with a view to potential changes in the Solvency II standard formula and draw up a report at the latest by 2023;

(ii) Regularly review the evidence on trends in the frequency and severity of natural disasters and EU insurers' exposure to such disasters with a view to potential changes in the Solvency II standard formula catastrophe risk modules;

2. REDUCING UNDUE VOLATILITY IN SOLVENCY II

In order to address the problem of *insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies*, Option 3 – "Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes, has been retained as part of the overall package of "preferred options" for the impact assessment. The aim of this section is to give a high-level overview of the envisaged changes to Solvency II to reduce undue volatility which are included in Option 3.

2.1. Revising the volatility adjustment.

The volatility adjustment is an adjustment to the regulatory (risk free) interest rates that are used to value insurers' liabilities towards policyholders. This adjustment aims at mitigating the impact on insurers' capital resources from short-term irrational movements in bond spreads. It encompasses a general adjustment per currency and a country-specific adjustment aiming at mitigating the impact of asymmetric short term spread crises in specific Member States.

As explained in the Evaluation Annex, the review should aim at addressing the deficiencies of the volatility adjustment, notably:

- The fact that depending on the nature of assets and liabilities, the level of the volatility adjustment may "over-react" during crisis situations – i.e. insurers in some countries may have a higher solvency position under crisis situations (e.g. the Covid-19 crisis during March 2020) than under normal conditions. This "overshooting" effect has been noted in Belgium and Netherlands for instance;
- The fact that in some countries, the country-specific component may not be sufficiently responsive to country-specific spread crises due to the existence of cliff-edge effects in the calculation formula. This "undershooting" effect has been noted in countries such as Italy, Spain, Portugal and Greece.

EIOPA's proposals would aim at addressing those two issues by:

- introducing an adjustment factor in the formula which would address the overshooting issue (the level of the volatility adjustment would be reduced when the duration of assets is lower than the duration of liabilities); and
- revising the formula of the country-specific component so that it is triggered in a more smoothly manner and removes cliff-edged effects.

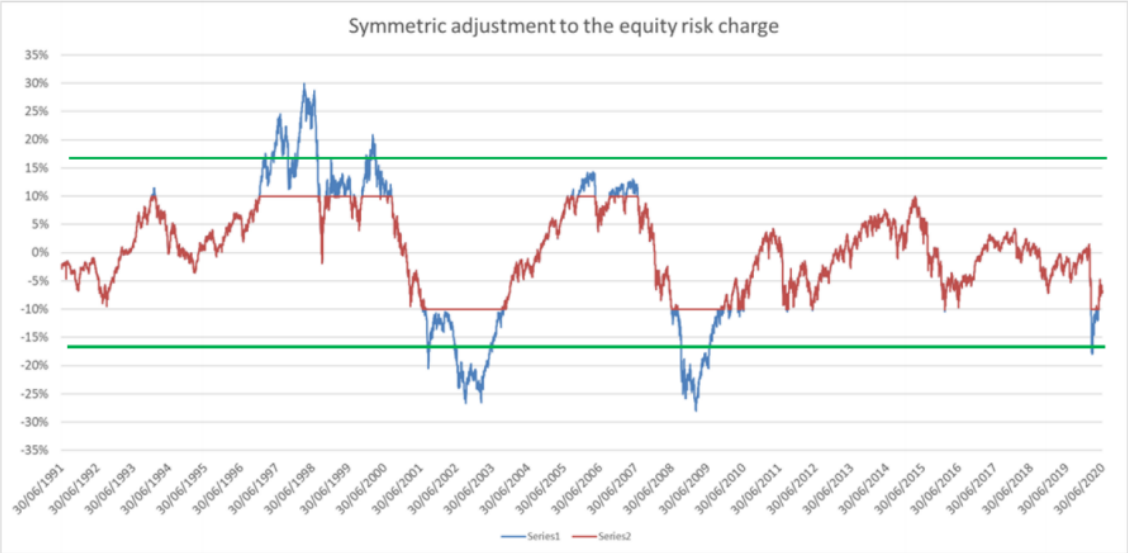
	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material cost	Improves policyholder protection by better mitigating volatility in a technically sound manner.
Insurers	Additional compliance costs as a new factor for overshooting would have to be calculated. No impact of the revised country-component.	Over-shooting and undershooting effect generate undue volatility in insurers' solvency, which provides wrong risk management incentives and fosters short-termism. Therefore, insurers would benefit removal of such effects.
Supervisors	Higher complexity in calculation and more scrutiny needed to supervise the use of the volatility adjustment.	The variation of the solvency position of insurers is more aligned with their risk profile, which facilitates the supervision by NSAs. Therefore, more efficient supervision.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	A less volatile solvency ratio facilitates long-termism in investment and underwriting decisions.	++
	Risk sensitivity and volatility	Significant improvement to volatility mitigation.	+++
	Proportionality	Increased complexity in the calculation.	-
	Quality of supervision - protection against failures	A more efficient volatility adjustment would ensure that solvency ratios are not subject to undue volatility which could result in wrong supervisory actions by NSAs. However, the calculation formula is more complex.	+/-
	Financial stability	By reducing volatility, the revised volatility adjustment would reduce the risk of procyclical behaviours by insurers.	++
Efficiency (cost-effectiveness)		The negative side effects in terms of additional complexity are outweighed by the benefits stemming from a more efficient volatility-mitigation effect, both at micro-level (more competitive insurance sector, greater ability to make long-term investments) and macro-level (lower risk of procyclical behaviour and therefore improved financial stability).	++

2.2. Revising the symmetric adjustment on equity risk

The *symmetric adjustment on equity risk* is an adjustment, which modulates equity capital charges depending on the state of stock markets (higher capital charges apply when markets are overheating, lower requirements when markets are plummeting). Currently, this adjustment is calculated according to a prescribed formula, but is capped/floored to +/- 10 percentage points (so-called "corridor"). This corridor proved to limit the countercyclical effect of the symmetric adjustment during the Covid-19 crisis, and in particular, during the month of March. Indeed, when markets fell, the corridor constrained the decrease in capital charges on equity to 10 percentage points only. For this reason, EIOPA and the ESRB propose to extend the corridor to +/- 17 percentage points [the value of 17 percentage points has been chosen so that no capital charge can go below 22%, which is the lowest value for standard formula equity capital charges under Solvency II].

The following diagram provided by EIOPA shows the development of the symmetric adjustment since 1991. The green lines represent the proposed alternative corridor (+/-17%). The corridor would have resulted in a higher adjustment during the period of increasing equity prices from 1997 to 2000: The symmetric adjustment would have been equal to its maximum almost without interruption from May 1997 to August 1988 and from February 2000 to March 2000. It would have resulted in lower symmetric adjustment during the equity downturns 2001 to 2003 and 2009 to 2010: The symmetric adjustment would have been equal almost continuously to - 17% from June 2002 to June 2003 and from October 2008 to July 2009. In those situations, the corridor would have limited the symmetric adjustment, while still improving the countercyclical effect of this tool than under current rules.



At the end of March and April 2020 the symmetric adjustment was at -10% under current rules, but with the proposed wider corridor, it would have been at -13,07% and - 10,26% respectively. Compared to a zero adjustment, capital requirements would have decreased on average by 3.9% if the symmetric adjustment had been -17% and increased by 4.2% if the symmetric adjustment had been +17% at the end of 2019. The impact is approximately symmetric.

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact	A wider corridor would enhance the impact of the symmetric adjustment, hence increasing the resilience of insurers during times of high equity prices, and improving policyholder protection.
Insurers	No material impact. The cost of equity investments would be higher than under current rules when markets are overheating.	A wider corridor would enhance the impact of the symmetric adjustment, hence stabilizing the solvency position of insurers in times of equity market turbulences.
Supervisors	No material impact	No material impact

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	The widened corridor would make the solvency ratio less volatile depending on stock market fluctuations. Therefore, it would facilitate long-termism in investment decisions. However, when equity prices are overheating, the cost of holding equity would be increased compared to normal times, fostering countercyclical behaviours.	+/-
	Risk sensitivity and volatility	The widening of the corridor would make the solvency ratio less volatile depending on the evolution of stock markets. However, it would somehow reduce the risk-sensitivity of capital requirements on equity investments.	+
	Proportionality	No impact	0
	Quality of supervision - protection against failures	No impact	0
	Financial stability	By enhancing the countercyclical nature of the adjustment, the widening of the corridor would contribute to financial stability.	++
Efficiency (cost-effectiveness)		The increased corridor of the symmetric adjustment would improve the countercyclical nature of the framework, with	+

	strong positive impact on financial stability. While it would further reduce capital requirements under crisis situations, it would also increase requirements when markets are overheating. Some stakeholders consider that such an effect would not be consistent with the objectives of the Capital Markets Union. In practice though, the widened corridor would ensure that insurers follow a longer term approach when investing in equity by ensuring that they are able to stick to their investments and meet the associated capital requirements regardless of the state of stock markets.	

3. BALANCING THE CUMULATIVE IMPACT OF THE REVIEW ON CAPITAL REQUIREMENTS

In order to address the problem of *insufficient risk sensitivity and limited ability of the framework to mitigate volatility of the solvency position of insurance companies*, Option 3 – "Address issues of risk sensitivity and volatility while balancing the cumulative effect of the changes, has been retained as part of the overall package of "preferred options" for the impact assessment. The aim of this section is to clarify more concretely how the balance is achieved.

3.1. Achieving the balance partly through phasing-in periods

A first approach to achieve the balance is to rely on the smoothening over time of the changes on interest rates, which have the most significant negative effect on insurers' capital requirements. Based on EIOPA's impact assessment, and depending on the level of interest rates:

- Amending capital requirements leads to additional requirements of between EUR 20 billion and EUR 25 billion;
- Amending rules governing the valuation of insurers' long term liabilities to policyholders reduces capital resources of between € 34 billion and € 70 billion.

For this reasons, and in line with EIOPA's advice, changes in relation to interest rates would be phased in so that their negative impact is progressively implemented over time. More precisely, EIOPA proposes to spread the impact on capital requirements over five years, so that the yearly impact of insurers would be between € 4 billion and € 5 billion.

As regards changes to the valuation rules which has a more significant impact, it has to be noted that Solvency II, when it adopted, included a long transitional period until 2032 so that insurers are given sufficient time to make their underwriting policies evolve (and notably to avoid excessive guarantees on life policies). EIOPA proposes to align all transitional periods on valuation so that the change related to the low interest rates environment would only be fully implemented in 2032.

Arguments in favour of those transitional periods	Arguments against those transitional periods	Conclusion
- Avoids a market-disruptive impact of changed on interest rates; - Acknowledges that the risk of insurance run (i.e. consumers rushing to withdraw their savings from life policies) is significantly lower than that of "bank run" and that the low-yield risk will only materialise (and	- Reduces the short-term effectiveness of changes aiming to improve risk sensitivity - Means that in the short term, the risk is not appropriately captured and this can affect policyholder protection - There may be side effects on financial stability risks	The cumulative impact of changes on interest is significant. The transitional period is acceptable as it is quite short (if the new Directive enters into application in 2026, this means only six years of "transition). In addition, as average insurers' capital resources currently remain largely above the regulatory

therefore has to be addressed) over the long-term - The limited short-term impact will avoid any impediment to EU insurers' competitiveness	as during the transitional period, the framework does not provide all necessary disincentives to excessive risk taking	requirements, they still have sufficient buffers to weather interest rate risks at this stage. **Therefore, transitional measures are included in the preferred Option**

3.2. Achieving the balance partly through "compensating measures"

A second approach to achieve the balance is to introduce "compensating measures" which would reduce capital requirements where justified. Below are outlined the technical changes in addition to EIOPA's approach to achieve a more balanced outcome of the review.

3.2.1. Reviewing the volatility adjustment

The volatility adjustment is an adjustment to the regulatory (risk-free) interest rates that are used to value insurers' liabilities towards policyholders. This adjustment aims at mitigating the impact of short-term irrational movements in credit spreads on insurers' capital resources. It encompasses a general adjustment per currency and, in the case of Euro Area countries, a country-specific adjustment aiming at mitigating the impact of spread crises that occur in certain Member States only (and not in the whole Euro Area)[176]. However, the effectiveness of this adjustment in mitigating volatility depends on the very characteristics on each national market:

- In some Member States (e.g. the Netherlands, Belgium), the adjustment is considered "too high" (i.e. in crises situations, the volatility adjustment makes a company better off than under normal conditions) – so called "**overshooting**" of the volatility adjustment;
- In other Member States (e.g. Italy, Spain, Portugal, Greece), the volatility adjustment is deemed "too low" (i.e. despite the existence of a country-specific component, the volatility adjustment is unable to appropriately mitigate the higher volatility in spread levels of southern countries) – so-called "**undershooting**" of the volatility adjustment;
- Finally, in a few countries (in particular, in France), the adjustment is deemed working well.

EIOPA put forward proposals aiming at increasing the default level of the volatility adjustment, at improving the functioning of the country-specific component and at addressing both the "over- and undershooting" issues. Those proposals are largely supported by all types of stakeholders as improving the functioning of the volatility adjustment.

However, EIOPA also proposes to adjust downward the volatility adjustment to reflect the so-called "illiquidity" of liabilities (insurers' liabilities are deemed illiquid if net cash-outflows are predictable and stable). Insurers with fully illiquid liabilities would not be imposed a downward adjustment, whereas other insurers would be "penalised" via a less powerful adjustment.

However, in addition to reducing the ability of the adjustment to address volatility, such an "illiquidity" adjustment would raise several concerns and has side effects:

- In light of EIOPA's technical specifications, the new illiquidity component of the volatility adjustment would reward in the current low-yield environment insurers

[176] The volatility adjustment per currency is calibrated on a "representative portfolio" of assets, which would cover the portfolio of insurance liabilities denominated in that currency. The volatility adjustment per country is calibrated on the basis of a "representative portfolio" of assets, which would cover insurance liabilities sold in the insurance market of that country and denominated in the currency of that country.

which offer unsustainably high guaranteed rates on life policies, possibly raising financial stability risks ; therefore, this adjustment is not efficient

- The recently adopted Regulation (EU) 2019/1238 on a pan-European Personal Pension Product (PEPP) is aimed at fostering the supply of private pensions in Europe across border. However, one of the characteristics of the PEPP is its portability (i.e. the ability to change provider). This portability feature would imply that insurers providing PEPP products would be classified as having "liquid" liabilities. Therefore, insurers would be at a disadvantage vis-a-vis insurers selling national products with no portability. This would not be coherent with the objective of developing the PEPP (also reiterated in the Capital Markets Union Action Plan)
- Currently, the volatility adjustment is a simple tool the value of which is centrally derived by EIOPA. Under the new approach, each insurer would have to calculate its own volatility adjustment. This creates undue burden for smaller and less complex insurers, which may decide to rely on the volatility adjustment anymore, even if it is at the cost of higher volatility of the solvency ratio. Therefore, the illiquidity adjustment would not be coherent with the Better Regulation agenda.
- EIOPA proposes that insurers' liquidity risk is measured by calculating the standard formula level of capital requirements for increased mortality or exercise of redemption rights. Therefore, EIOPA is double counting the same risk in the capital requirement and through the level of the volatility adjustment when valuing its liabilities.

For those reasons, Option 3 removed the illiquidity adjustment. Based on EIOPA's impact assessment and Commission services' proxy calculations (with very simplifying assumption, notably that insurance liabilities behave linearly with interest rates), it is estimated that the impact of this adaptation would lie between € 5 billion and € 11 billion in terms of additional capital resources.

3.2.2. Reviewing the risk margin

The risk margin is one of the components of insurers' liabilities towards policyholders representing the potential costs of transferring insurance obligations to a third party should an insurer fail. It is calculated as the product of a cost-of capital rate (currently set at 6%) and the present value of expected future capital requirements stemming from holding insurance contracts. The risk margin has been subject to heavy criticisms over the recent years by both insurance stakeholders and the European Parliament. Indeed, its level and volatility are deemed too high, especially for insurance products covering longevity risks e.g. annuities. According to those stakeholders, this fact is allegedly restricting insurers' ability to continue offering long-term products with guarantees and to make long-term investments. EIOPA proposes an adaptation to the formula, which would reduce both the level (by around 15%) and the volatility of the risk-margin[177]. However, EIOPA did not reassess the appropriateness of the cost-of-capital rate despite the request from the Commission services to analyse the arguments put forward by the industry on this topic[178].

Several stakeholders are claiming that the 6% cost-of-capital rate should also be reviewed. This value was set before the Directive entered into application in 2016, and has never been

[177] Broadly speaking, EIOPA's proposal consists in introducing a new parameter ("lambda factor") which reduces the contribution of projected capital requirements that would stem from holding insurance contracts in the long run (i.e. long-term projected SCRs would have a lower weight than under current rules). However, according to EIOPA's proposal, the mitigating effect of this factor would be capped, so that future SCRs cannot be reduced by more than 50% in comparison with the current formula. As EIOPA does not provide concrete justifications of this cap, the Commission services do not intend to include this floor. The impact is moderate – between EUR 600 million and EUR 900 million depending on market conditions.

[178] See section 3.4 of the Commission's Call for Advice to EIOPA on the review of Solvency II.

revised. However, in order to be consistent, it should be acknowledged that the cost-of-capital rate also needs to reflect the low-yield environment. For this reason, it seems acceptable to proceed to a 1 percentage point decrease in the cost of capital rate (down to 5%). This decrease would also be consistent with the downward trend of lower guaranteed rate on insurance policies, which make up the major share of an insurer's balance sheet. The insurance industry is requesting a 3 percentage points decrease in the cost of capital but this would not be substantiated by evidence and would lead to an excessive cut in the risk margin. On the contrary, a 1 percentage point decrease in the cost of capital rate would allow cutting the risk margin by only 17% (€26 billion of additional capital resources). For this reason, **Option 3 includes a 1 percentage point decrease in the cost of capital rate in addition to EIOPA's proposals.**

3.2.3. Assessment of the balance of the "package"

Based on EIOPA's impact assessment, the Commission services have assessed the average impact of Option 3 of the core part of the impact assessment on the excess capital of insurance companies and on solvency ratios, at two different reference dates (end of 2019 – before the Covid-19 crisis – and mid-2020 – during the Covid-19 crisis)[179].

	Reference date end of 2019		Reference date mid-2020	
	Change in solvency ratio compared to under current rules	Change in excess own funds compared to current rules	Change in solvency ratio compared to under current rules	Change in excess own funds over compared to current rules
Option 2 (EIOPA)	-13 percentage points *(from 247% to 233%)*	- EUR 15 billion (sample) - EUR 18 billion (whole market)	-22 percentage points *(from 226% to 204%)*	- EUR 40 billion (sample) - EUR 55 billion (whole market)
Option 3 (preferred)	-2 percentage points *(from 247% to 245%)*	**+ EUR 16 billion (sample) +30 billion (whole market)**	-3 percentage points *(from 226% to 223%)*	**+ EUR 8 billion (sample) +16 billion (whole market)**
	Reference date end of 2019		Reference date mid-2020	
	Change in solvency ratio compared to under current rules	Change in excess own funds compared to current rules	Change in solvency ratio compared to under current rules	Change in excess own funds over compared to current rules
Option 2 (EIOPA)	-13 percentage points *(from 247% to 233%)*	- EUR 15 billion (sample) - EUR 18 billion (whole market)	-22 percentage points *(from 226% to 204%)*	- EUR 40 billion (sample) - EUR 55 billion (whole market)
Option 3 (preferred)	-2 percentage points	**+ EUR 16 billion (sample)**	-3 percentage points	**+ EUR 8 billion (sample)**

[179] Note that the Commission services are considering an additional change compared to EIOPA's advice, regarding the way of implementing the incorporation of negative interest rates in the calculation of capital requirements for interest rate risk. In particular, the Commission services note that there is a discrepancy between the approach used to derive the regular risk-free rate curve and the method used to derive the "stressed" risk-free rate curve. More precisely, for the purpose of interest rate risk, there is no acknowledgement that long-maturity rates do not stem from market data but are derived by using some mathematical extrapolation approach. An alignment between the two approaches could be envisaged (i.e. ensuring that "stressed" rates are derived in a similar manner as regular rates). At the time of submission of this impact assessment, the final decision has not been made yet. However, for the purpose of allowing stakeholders to know the potential maximum impact of the review, this change is supposed to be implemented in the table of quantitative impact.

	(from 247% to 245%)	**+EUR 30 billion (whole market)**	*(from 226% to 223%)*	**+EUR 16 billion (whole market)**

Therefore, Option 3 is the only option which achieves the objective of balanced outcome (neutrality in surplus, slight decrease in solvency ratios) while improving the risk sensitivity of the framework.

4. ENHANCING GROUP SUPERVISION

As part of the problem of *deficiencies in the supervision of insurance companies and groups*, Option 2 – "Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision" has been retained as part of the overall package of "preferred options" for the impact assessment. This option encompasses clearer rules on group supervision. The objective of this section is to clarify in broad terms what is potentially envisaged as part of the enhanced group supervision.

Option 2 embeds improvements on group supervision with the aims of (i) strengthening and harmonising supervisory powers towards groups including when their headquarter is in a third country or when the parent company is a non-regulated entity[180], and (ii) clarifying prudential rules on capital requirements and risk management which are subject to diverging interpretations by Member States[181].

This section will discuss the merits of the main proposals on group supervision. It leverages on the very granular impact assessment by EIOPA and does not aim to conduct another impact assessment (but to simply justify the technical choices made). When discussing effectiveness, we will assess the merits of each option against the different specific objectives of the core part of the impact assessment. In addition, as insurance groups can have an international footprint that goes beyond European borders, we assess the different options against the general objective of international competitiveness.

4.1. Strengthening and harmonising supervisory powers towards groups

4.1.1. Exercising group supervision in case of complex or unclear corporate structure

Issue: In most cases, groups are characterised by a transparent structure with a clearly defined parent company. However, in other cases, group structures or corporate organisations may hinder the exercise of group supervision. For instance, several companies which do not have capital ties between one another and therefore do not form a group per se may still act in full coordination (as if they were a group) – e.g. because the persons running the companies have close ties. In such cases of "horizontal groups" (i.e. groups with no clearly defined parent company), the supervisor has no possibility to impose group supervision. In other cases, there may be difficulties in imposing group supervision, e.g. when a non-insurance group, possibly headquartered outside Europe, has subsidiaries in Europe. This can concern cases of leveraged buy-out where an unregulated entity acquires insurance companies through debt financing while circumventing group supervision.

[180] Proposal includes better framing of cases where an authority may completely waive group supervision (under the control of EIOPA), clarifying powers over unregulated parent companies of a group, power to restructure the group where the corporate structure is such that it prevents effective supervision, strengthened supervision of groups whose parent company is outside Europe to avoid incentivising groups to circumvent Solvency II requirements by establishing their head office outside Europe.

[181] This includes clarifications on how to account for equivalent third-country insurers in the group solvency calculation (currently, a legal gap allows to not take account of currency risk), to account for small subsidiaries (proportionality), to integrate non-insurance financial institutions and on rules governing capital transferability within a group.

Recommendation by EIOPA: Supervisors should have the power to:

- exercise group supervision even if there is no corporate group, where it is clear that decisions and strategies of different companies are coordinated with one another;
- require the restructuring of a group where group supervision cannot be otherwise exercised.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material cost	Improved policyholder protection through enhanced group supervision.
Insurers	Regulatory burden for entities/groups for which group supervision is extended or restructuring is required.	Improved level-playing field and legal certainty. Impact is expected to be null on existing groups, but will affect those insurers trying to circumvent regulatory requirements.
Supervisors	Higher supervisory costs in case of extension of group supervision.	More legal certainty in supervisory activities, and more effective and efficient group supervision.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve quality of supervision and reduce the risk of regulatory arbitrage; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Very limited side effects (costs for the groups concerned) which are outweighed by the improved level-playing field and quality of group supervision.	++

Conclusion: This policy recommendation is cost effective, by granting powers to supervisors while clarifying that this is a last resort measure aiming to avoid regulatory arbitrage. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

4.1.2. Exercising group supervision over unregulated parent holding companies

Issue: In some cases, insurance groups are headed by a non-regulated holding company. Depending on national implementation of Solvency II, those groups may or may not be subject to group supervision: Supervisors have discretion in assessing whether the main activity of the holding company is to hold and manage insurance subsidiaries (in which case group supervision applies) or not (in which case public authorities only supervise intragroup transactions). In addition, even if group supervision should apply, several supervisory authorities reported that they have no or insufficient supervisory powers towards top unregulated entities of insurance groups. This leads to an inconsistent application of group supervision within the Union, which is not justified – in particular when taking into account the particular responsibilities the concept of group supervision places on the parent company and its governance framework.

Recommendation by EIOPA:

- Clarify, in line with banking rules[182] which parent holding companies trigger full group supervision at their level;
- Ensure that supervisors have the necessary enforcement powers over parent holding companies or to require the parent company to ensure a corporate structure that enables group supervision.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection through more effective group supervision.
Insurers	Additional capital requirements and compliance costs for those groups which according to national implementation are subject to full group supervision or to which group supervisors apply their new enforcement powers.	More clarity and legal certainty, and greater level-playing field.
Supervisors	Potential increase in supervisory tasks depending on whether new groups are subject to group supervision.	More clarity and legal certainty, and more effective supervision through more powers over parent companies.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	By ensuring that unregulated holding companies are captured in group supervision, the risk sensitivity of capital requirements (i.e. the ability of the group SCR to capture all risks) is improved.	+
	Proportionality	No impact identified.	0
	Quality of supervision – protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Very limited side effects (costs for the groups concerned) which are outweighed by the improved level-playing field and quality of group supervision.	++

Conclusion: This policy recommendation is cost effective, by granting powers to supervisors aiming to ensure that group supervision can be exercised over parent holding companies. The definition of holding companies itself converges with the approach followed in the banking sector.

4.1.3. Exclusion from group supervision

Issue: The Solvency II directive provides the option to NSAs to exclude a company from the scope of group supervision. However, Member States shall also provide for supervision of insurance groups. The exclusion of a company from the scope of the group supervision

[182] See Regulation (EU) 2019/876.

leading to a waiver of the group supervision is not in the spirit of the Solvency II directive, especially on the basis of justification that this company is of negligible interest with respect to the objectives of group supervision.

In practice, different supervisory approaches regarding the exclusion of a company from the scope of the group supervision are observed (some NSAs do waive group supervision whereas others would never follow such an approach) which leads to inconsistencies between Member States and an uneven level-playing field.

Recommendation by EIOPA:

- Introduce an overall principle on the exclusion of companies from group supervision to ensure exceptional cases are adequately justified, documented and monitored. A waiver of group supervision should only be possible in exceptional circumstances after consultation of the group supervisor with all relevant supervisors as well as EIOPA;
- Introduce several criteria to be taken into account when evaluating if the exclusion of a company might be acceptable, as it is of "negligible interest" with respect to the objective of group supervision.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection through more effective group supervision.
Insurers	Additional compliance costs for those groups excluding companies which are not deemed of negligible interest or which had group supervision waived, will face compliance costs fulfilling requirements under group supervision.	More clarity and legal certainty, and greater level-playing field.
Supervisors	Increase in supervisory tasks for those groups whose scope of supervision is widened.	More clarity and legal certainty; more effective and consistent supervision across the Union.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Very limited side effects (costs for the groups concerned) which are outweighed by the improved level-playing field and quality of group supervision.	++

Conclusion: This policy recommendation is cost effective, by applying the Solvency II framework in a more consistent manner by a coherent inclusion of companies belonging to a group as well as closing gaps to circumvent group supervision.

4.1.4. Supervision of third country insurance groups

Issue: A large number of insurance groups is active in the EEA although their ultimate parent company is located in a third country (i.e. outside the EEA). EEA supervisors do rely under certain conditions on the group supervision exercised by a third country, if the local rules are deemed equivalent in this area. For all other groups the competent EEA group supervisor may apply relevant Solvency II requirements via an EEA company to the worldwide group as if it was based in the EEA. Such an approach if for obvious reasons not practicable in most cases. Alternatively, Solvency II offers the possibility to apply "other methods" to ensure appropriate group supervision. As the concept of "other methods" is not further specified and leaves much room for interpretation, in practice the intensity of supervision of such groups varies widely. This faces potentially significant harm to European policyholders if there are significant risks, which are not appropriately identified or mitigated, e.g. risks stemming from intra group financing. It can also incentivise EU-based groups to move their parent company outside the EEA if they can hope to circumvent Solvency II group requirements.

Recommendation by EIOPA:

- The concept of "other methods" should be kept whilst clarifying its objectives and meaning with the view of giving a clearer mandate to NSAs on what they should do when supervising Third-Country groups;
- EIOPA should be also be consulted in the consultation process on "other methods".

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection through more effective group supervision.
Insurers	Additional compliance costs for those groups on which currently a light concept of other methods is imposed.	More clarity and legal certainty, and greater level-playing field.
Supervisors	Potential increase in supervisory tasks for those groups on which the concept of other methods will be strengthened.	More clarity and legal certainty; more effective and consistent supervision across the Union.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	Significant improvement of EU insurers' competitiveness as supervisors would be required to exercise stronger scrutiny over Third-Country groups with the aim of ensuring that there is no circumvention of Solvency II group rules by establishing a parent company outside the EEA.	+++
Efficiency (cost-effectiveness)		Very limited side effects (costs for the groups concerned) which are outweighed by the improved level-playing field and quality of group supervision, as well as the material improvement of the competitiveness of EU groups.	++

Conclusion: This policy recommendation is cost effective, by applying the Solvency II framework in a more consistent manner in the supervision of non-EEA insurance groups.

4.2. Clarifying prudential rules on capital requirements

4.2.1. Simplified calculations for small insurers

Issue: As a basic principle, all insurance companies belonging to an insurance group have to be included in the *group* Solvency Capital Requirement calculation based on Solvency II calculations. This can sometimes prove to be very complex, for instance for small subsidiaries in developing markets, and the framework currently offers limited simplified approach when this general approach is operationally burdensome (the Directive allows removing the book value of that entity from the group's capital resources, which can be very penalising for the groups). In practice though, some insurance groups have developed other simplified approaches, which vary greatly within the Union leading to unequal conditions for insurance groups among the Union.

Recommendation by EIOPA:

- Introduce a new simplified approach which is sufficiently conservative to appropriately capture relevant risks, but which is less penalising than the full deduction of the book value of the entity;
- This simplified approach should only be applied to the extent that the entities concerned are small in relation to the group balance sheet (introduction of maximum materiality thresholds);
- Prior approval by the group supervisor is required.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	No material impact.
Insurers	Additional compliance costs for those groups, which currently exclude entities in a more liberal way than under the new concept; vice versa reduced compliance costs for those groups not using the concept currently.	More clarity and legal certainty, and greater level-playing field; calculation is less burdensome for small companies.
Supervisors	Potential increase in supervisory tasks by the approval of the simplified approach.	More clarity and legal certainty; more effective and consistent supervision across the Union in particular as maximum thresholds for simplified calculations.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	EIOPA's proposal would allow groups in a consistent and effective way to include small immaterial companies from third countries into the calculation of capital requirements.	++
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0

	International competitiveness	Slightly positive impact by limiting the regulatory compliance cost of expansion at international level.	+
Efficiency (cost-effectiveness)		Very limited side effects (costs for the groups concerned) which are outweighed by the improved level-playing field and effectiveness of group supervision.	++

Conclusion: This policy recommendation is cost effective, by applying the Solvency II framework in a more consistent manner in the supervision of non-EEA insurance groups. It acknowledges that European groups are investing and expanding outside the EEA, and that groups need rules that also facilitate an international level-playing field by not putting policyholder protection at risk.

4.2.2. "Combination of methods"

Issue: The group Solvency Capital Requirement under the Solvency II framework can be calculated through two different methods. It offers also the possibility to combine the two methods, which is attractive for EEA-groups with insurance companies located in equivalent third country jurisdictions (because in that case, local prudential rules can be used to aggregate risks to the insurance groups instead of Solvency II rules). The interpretation of current rules implies that some risks are possibly overlooked[183].

Recommendation by EIOPA: Groups using the above-mentioned approach should also take into account those risks (notably currency risk) which are currently not considered in the calculations.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection through increased risk sensitivity of the framework.
Insurers	Significant additional cost of capital for groups, which are very active in equivalent jurisdictions using the combination of methods.	More clarity and legal certainty, and greater level-playing field by increasing risk sensitivity of the framework.
Supervisors	Potential slight increase in supervisory tasks through supervision of changed methodology.	Increase in the efficiency and effectiveness of supervision through increased risk sensitivity of the framework.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	The inclusion of risks which are currently potentially overlooked will increase the risk sensitivity of the framework.	++
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0

[183] This is in particular the case for currency risk. For example, if an EEA-group with Euro-denominated assets and liabilities includes its US based subsidiary by taking into account the local US capital requirements, which are based on US Dollars and are converted into EUR. The currency risk stemming from the potential mismatch between this US subsidiary's currency and the group's currency due to volatility in exchange rates is not taken into account. Another risk is market concentration risk.

	International competitiveness	Additional cost of capital potentially leading to a deterioration of the international competitiveness of such groups. At the same time, the increased risk sensitivity will increase the resilience of insurance groups potentially leading to a stronger position in the markets.	--
Efficiency (cost-effectiveness)		The increased costs for the groups concerned are outweighed by the increased risk sensitivity of the framework, the improved level-playing field and the effectiveness of group supervision.	+

Conclusion: The increase in costs for affected international active insurance groups might have a negative impact on their international competiveness. These costs will be outweighed by the increase in the risk sensitivity of the Solvency II framework and subsequently in policyholder protection. There are different ways of taking into account currency and concentration risks stemming from third-country insurers in capital requirements. The Commission services will chose the technical approach which makes economic sense while note having undue disruptive effect on any group. According to EIOPA's impact assessment, the decrease in solvency ratios stemming from this option is on average below 1%.

4.2.3. Own funds supervision

Issue: Insurance companies must hold assets to cover their liabilities. In addition, the Solvency II framework requires to hold own funds (capital resources) to weather adverse situations or developments which is reflected in the specific capital requirements. The same concept applies for insurance groups. With regards to own funds there are unclear rules governing how to ensure that specific capital items recognised within individual insurance companies are indeed available and transferable within the group to potentially absorb losses of other insurance companies for the sake of policyholder protection[184].

Recommendation by EIOPA: Clarify the rules governing the eligibility and availability of own funds within an insurance group.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection.
Insurers	Potential increase in financing cost for some groups; increased costs in demonstrations that specific capital items are available and transferable within the group; potentially increased costs if capital position is rejected by the supervisory authority.	More clarity and legal certainty, and greater level-playing field following a harmonisation of the regulatory framework.
Supervisors	Potential increase in costs resulting from additional supervisory reviews on specific own fund items.	Increase in the efficiency and effectiveness of supervision through increased risk sensitivity of the framework.

		Impact of EIOPA's proposals (compared to "no change")	
Effect ivene	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0

[184] For example, the framework needs to be clear on the conditions under which subordinated debt issued by a non-regulated firm within an insurance group can be accounted for to cover potential capital needs resulting from a winding up of insurance companies within the group.

	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		The limited side effects (costs for the groups and supervisory authorities) are outweighed by the improved level-playing field and effectiveness of group supervision.	++

Conclusion: This policy recommendation is cost effective, by applying the Solvency II framework in a more consistent manner by a coherent consideration of available own funds within an insurance group leading to a greater level-playing field and an increase in policyholder protection.

4.2.4. Minimum consolidated group Solvency Capital Requirement

Issue: Individual insurance companies have to be hold adequate levels of capital to be able to fulfil their obligations under the insurance policies. In addition the Solvency II framework requires to hold additional capital to weather adverse events or developments[185], the Solvency Capital Requirement (SCR). A breach of the SCR results in supervisory measures imposed on the insurance company. If another threshold, the Minimum Capital Requirement (MCR), which is between 25% and 45% of the SCR, is breached, supervisors will take ultimate supervisory action, e.g. stop the company to do new business.

There is also a group SCR for insurance groups. The framework does not foresee the concept of a group MCR but of another "minimum threshold". When this other threshold is breached, insurers are required to default on some of their debt instruments. Due to a different scope of companies being considered in the calculation, under particular circumstances this "minimum threshold" could be breached and lead to unintended consequences (of being required to default) although the group SCR as the basic target capital requirement is not breached.

Recommendation by EIOPA:

- The calculation of the group SCR and the other threshold should be aligned with respect to the companies taken into account in the calculation;
- The existing "minimum threshold" will only be used as a floor to calculate the group SCR; i.e. regardless of the way capital requirements and diversification benefits are calculated, the group SCR can never fall below that floor;
- Introduction of a new metric similar to a group MCR as a percentage of the minimum target capital requirement, which would be used to determine whether an insurance group should default on its debt instruments. This new metric would be set in such a way that the default cannot occur before the group SCR is breached.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Enhanced policyholder protection through consistent application of the framework preventing unjustified supervisory action on sound insurance groups.
Insurers	Increase in costs as more entities	Avoidance of insurance groups breaching

[185] For example caused by increased claims costs or adverse development in capital markets reducing the value of the insurance company's assets.

	would be included in the calculations with a potential impact on marginal costs to calculate, report and comply with the new metrics.	regulatory requirements, which are technically not justified and unintended by the framework.
Supervisors	Costs derived from the application of the new metrics in supervision.	Increase in the efficiency and effectiveness of supervision through avoidance of insurance groups breaching regulatory requirements, which are technically not justified and unintended by the framework.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	An insurance group breaching its capital requirements and supervisors being forced to take supervisory action might cause distress in financial markets and build up systemic risk.	+
	International competitiveness	Easier access to capital financing as market participants would no longer fear the possible breach of regulatory requirement, which would trigger default by the insurer despite not based on a technically sound approach.	+
Efficiency (cost-effectiveness)		Very limited side effects (costs) which are outweighed by the improved consistency and effectiveness of group supervision.	++

Conclusion: This policy recommendation is cost effective, while increasing the consistent and coherent application of capital requirements also for insurance group. This leads also to an increase in policyholder protection and increased financial stability.

4.2.5. Treatment of companies from other financial sectors (banks, pension funds, etc.)

Issue: In some Member States in particular large insurance groups are often connected to banks. These structures raise issues as the application of banking rules within the Solvency II framework is not always clear. Regarding capital requirements, banking rules have different metrics (Common equity tier 1 ratio, tier 1 ratio, etc.) and buffers (for instance, systemic buffers), and the Solvency II framework does not specify which capital requirements should be taken into account when assessing the solvency position of a group. Similarly, regarding own funds, in view of the lack of legal clarity, it is possible for an insurance group to disclose a high solvency position even if the insurance part has limited capital resources, because the group is holding a well-capitalised bank/pension fund with sectoral-specific own funds which cannot be transferred to absorb insurance losses when needed. In such a case, the "rich" entity from another financial sector is leading to an overstatement of the insurance group's solvency, if the bank's wealth is not available to absorb losses in the insurance part.

Recommendation by EIOPA:

- Clarify the appropriate banking capital requirements which should be considered when calculating an insurance group's solvency position

- Clarify how to treat a bank's excess capital (i.e. capital resources above capital requirements)

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection through increased risk sensitivity of the framework.
Insurers	Potentially increased costs resulting in less flexible approaches under the proposed option.	More clarity and legal certainty as well as convergence of practice leading to a greater level-playing field.
Supervisors	Potential slight increase in supervisory tasks through supervision of changed methodology which allows less flexibility and requires individual assessments.	Increase in the efficiency and effectiveness of supervision through increased consistency and convergence in supervisory practice.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Very limited side effects (costs) which are outweighed by the improved consistency and effectiveness of group supervision.	++

Conclusion: The option is cost effective, while clarifying the application of the requirements in particular from the banking regulation in the Solvency II framework leading to a harmonised and consistent application across the Union and to increased policyholder protection.

4.2.6. System of governance of insurance groups

Issue: One key component of the Solvency II framework is the requirement for insurance companies to have in place an effective "system of governance" which provides for sound and prudent management of the business. In this respect, the executive and supervisory board of the insurance company has a prominent role as it holds ultimate responsibility for the company's compliance with the Solvency II framework. Insurance groups are also required to have in place an effective system of governance. However, due to regulatory gaps, the framework offers great flexibility to industry leading to an uneven level-playing field. Due to a gap in the legislation, the role of the executive and supervisory board of the insurance group's parent company is unclear.

Recommendation by EIOPA:

- Clarify the requirements on the system of governance for insurance groups;
- Clarify the role of the executive and supervisory board of the insurance group's parent company with regard to the group's system of governance.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No material impact.	Enhanced policyholder protection

		through clarified governance requirements for insurance groups.
Insurers	Potential costs resulting from changes on the group's system of governance depending on the current transposition of the Solvency II framework in individual Member States.	Harmonisation of the framework would increase the level-playing field.
Supervisors	Potentials costs resulting amended supervisory practice depending on the current national transposition of the Solvency II framework in individual Member States.	Increase in the efficiency and effectiveness of supervision through increased risk sensitivity of the framework.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	The strengthening of the groups' system of governance will increase their risk sensitivity.	+
	Proportionality	The proposal includes a proportionate approach to complexity and risks.	+
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	The increase in insurance groups' resilience should reinforce slightly financial stability.	+
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Very limited side effects (costs) which are outweighed by the improved consistency and effectiveness of group supervision.	++

Conclusion: This policy recommendation is cost effective, by clarifying the framework to enhance insurance groups' resilience and enhancing effective group supervision leading to a greater level-playing field and increased policyholder protection.

5. ENHANCING SUPERVISION OF CROSS-BORDER INSURANCE COMPANIES

In order to address the problem of *deficiencies in the supervision of (cross-border) insurance companies*, Option 2 – "Improve the quality of supervision by strengthening or clarifying rules on certain aspects, in particular in relation to cross-border supervision" has been retained as part of the overall package of "preferred options" for the impact assessment. Under this Option, the legal framework would be clarified and strengthened to ensure more quality and convergence of supervision, in particular in relation to cross-border and group supervision. The aim of this section is to clarify in broad terms what is embedded as part of the enhanced supervision on cross border insurance activities.

Option 2 contains improvements on supervision of cross border insurance activities with the aims of (i) ensuring more efficient information gathering/exchange during the authorisation process and ongoing supervision, (ii) improving cooperation between Home and Host supervisory authorities, under the coordination/mediation of EIOPA.

This section will discuss the merits of the main proposals on cross border supervision. It leverages on the granular impact assessment by EIOPA and does not aim to conduct another impact assessment (but to simply justify the choices made). It also contains some complementary proposals aiming to "upgrade" in the legal framework provisions which are

included in the Decision on Collaboration of the insurance supervisory authorities (non-binding agreement between supervisors within EIOPA).

5.1. Ensuring more efficient information gathering/exchange during the authorisation process and ongoing supervision

5.1.1. Efficient information gathering during the authorisation process

Issue: During the authorisation (licensing) process, the supervisory authority which receives the application does not necessarily know whether an application has already been submitted in other Member States, and if so, what the outcomes of such applications have been. Under the EIOPA Decision on Collaboration, it is expected that NSAs require that applicants indicate whether they have already applied in other Member States. However, the Decision on Collaboration is not binding for insurers and EIOPA refers to cases where such information was not submitted. Therefore, NSAs lack the necessary legal obligation for the industry across the EEA to submit information on previous applications.

Recommendation by EIOPA: Include in the Solvency II Directive the requirement, currently foreseen by the Decision on Collaboration, on the applicant to inform the NSA on rejections/withdrawals of former requests for licensing. By introducing this requirement, the NSA that receives the application would be in a better position to assess the condition for authorisation and collaborate with the NSA that rejected the authorisation in the past. Having the requirement in Level 1 opens the possibility for sanctions in cases where the insurer provides no or insufficient information.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Improved policyholder protection through a formal obligation. Addresses the risk of forum shopping by those applicants, which have been rejected elsewhere.
Insurers	The decision on former rejection(s) is already in the applicants' possession. Therefore, costs of providing this information would be limited.	Improved level-playing field and clear legal obligations.
Supervisors	This would be an "upgrade" of the text of the Decision on cooperation, no extra costs would be involved.	NSAs have a clear legal power to ask for the relevant information on earlier rejections of authorisations.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure and improved level-playing field; all this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0

Efficiency (cost-effectiveness)	Very limited side effects (costs) which are outweighed by the improved (consistency and effectiveness) information gathering on earlier rejection of authorisations.	++

Conclusion: This policy recommendation is cost effective, by granting powers to supervisors while ensuring an effective way of gathering information on earlier rejections, aiming to avoid forum shopping. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

5.1.2. Information exchange between Home and Host supervisors in case of material changes in cross-border activities

Issue: It is a common practice for insurers to communicate their intention to pursue cross-border activities, but often after that, they do not immediately start cross-border activities. On the contrary, they may start operating in other Member States only several years after the initial notification to the Host supervisor. The Host supervisor becomes aware of activity pursued in its territory with some delay, for instance at the moment of the distribution of some information regarding cross-border business by EIOPA. In addition, there may be cases where insurers change their initial business plan and to start operating exclusively, or almost exclusively, outside the Home Member State. In such case, no specific exchange on information between Home and Host supervisor is explicitly required by Solvency II. This lack of information makes it more difficult for NSAs to appropriately intervene when issues effectively arise, and the cost of late intervention is generally higher than that of more timely intervention. This can have a negative effect on policyholder protection.

Recommendation by EIOPA: Legal requirement for Home NSA to inform the Host NSA of material changes in the plan of operations where relevant for the Host NSA.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Improved policyholder protection as Host NSAs are better informed about the changes in the plan of operations through which policyholders could be affected.
Insurers	No material impact as the information exchange is amongst the NSAs.	NSAs will be better informed about the insurers' operations on the local market and this will lead to more efficient communication with the NSA.
Supervisors	More obligations for information exchange and costs for the Home NSA. The aim is to prevent taking later supervisory actions which would probably be more costly.	The Host NSA will be updated on substantial changes in the insurers' plan of operations and its activities on the local market – as such it will be better prepared to address issues if they arise.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure an improved level-playing field. Supervisors would be in a better position to prevent issues. All this contributes to enhancing	++

		policyholder protection.	
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		The increase in cost for the Home NSA would be outweighed by the ability for supervisors to intervene more timely when problems arise.	++

Conclusion: This policy recommendation is cost effective, by formalising information exchange from Home to Host NSA in case of material changes in cross-border activities. Early information exchange facilitates more timely intervention when problems arise (and as such reduce the cost of supervisory intervention). Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

5.1.3. Explicit power of the Host NSA to request information in a timely manner

Issue: Based on the current legal framework Host NSAs lack the power to request timely answers to information requests to foreign insurers operating in their territory (e.g. questions on conduct of business or specific product information). The Host NSA has to rely on the Home NSA to get this information, but the current framework does not foresee deadlines or enforcement measures regarding the lack of cooperation. If the requested information is not provided in a timely manner supervisory issues remain unsolved and can have negative impact on the policyholder protection.

Recommendation by EIOPA: Introduce an explicit power for the Host NSA to request information to an insurer within a reasonable timeframe to perform its supervisory activities more effectively.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Improved policyholder protection when Host NSAs are informed in a timely manner, which facilitates supervisory intervention when needed.
Insurers	Higher costs for insurers, which would have to respond to requests from both Home and Host NSAs.	Clear requirements for the provision of information.
Supervisors	Less costs for supervisors as information needs to be provided in a timely manner and repeated requests for information will be less frequent.	More timely access to information.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	Information requests directed to insurers would only occur in specific circumstances when timely information is needed.	+
	Quality of supervision - protection against failures	EIOPA's proposals would ensure more timely (and therefore more effective) access to information (and therefore, possibly more timely supervisory intervention) by Host Member States.	++

	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		By facilitating timely access to information when justified, this recommendation would improve quality of supervision. In addition, costs would be reduced by avoiding repeated requests.	++

Conclusion: This policy recommendation is cost effective, by providing explicit legal power for Host NSA to request information to foreign insurers in a timely manner. This can help prevent supervisory issues and reduce the risk of insurance failures. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

5.1.4. Access to minimum prudential data by Host supervisors

Issue: Host supervisors only have access to some statistical data and not prudential data. However, in order to ensure a closer cooperation when prudential concerns may arise, it would be needed for the Host supervisor to receive minimum timely information on the solvency position of the insurer (solvency ratio notably), which is currently only accessible on a yearly basis, once the public solvency and financial condition report is published.

Recommendation by the French and Italian Supervisory Authorities: Introduce a requirement for the Home NSA to share some (limited) information on the prudential situation of the insurer which is operating on a cross-border basis (own funds and solvency capital requirement).

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Improved policyholder protection as cooperation between Home and Host supervisors would be fostered by sharing some prudential information.
Insurers	No costs. The information would continue being provided to the Home NSA, which would have to share it with Host NSAs.	Clear awareness that both Home and Host supervisors know the solvency position of the insurer.
Supervisors	Some costs for the supervisor to share the information with the Host supervisor. However, the information is directly submitted by the insurer and the cost of sharing the information to other supervisory authorities remains limited.	More timely access to information for Host supervisors who can have the information earlier than under current rules (where they have to wait for the publication of the solvency and financial condition report by the insurer).

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	The prudential information shared with Host supervisors is limited to basic solvency information.	+
	Quality of supervision - protection against failures	EIOPA's proposals would ensure more timely (and therefore more effective) access to information by Host supervisors, which can facilitate future cooperation in case of financial difficulties by the insurer.	++
	Financial stability	No impact identified.	0

	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		The cost of sharing this information is limited, but it can facilitate timely cooperation when problems arise. This proposal should be read in conjunction with the one joint on-site inspections (see subsection 4.2.2 below).	+

Conclusion: This policy recommendation is cost effective, by fostering information sharing on basic prudential data. The Home supervisor remains responsible for compliance with capital requirements, but the Host supervisor would be in a position to know in a timelier manner whether cooperation with the Home supervisor is needed. This recommendation has to be read in conjunction with the one on joint inspections (possibility for the Host supervisor to request a joint on-site inspection in case of significant concerns on the solvency position of an insurer operating cross-border – see subsection 4.2.2. below). This can help prevent supervisory issues and reduce the risk of insurance failures. Therefore, Option 2 of the impact assessment endorses this recommendation of basic prudential information sharing between Home and Host supervisors.

5.2. Improving cooperation between Home and Host supervisory authorities, under the coordination/mediation of EIOPA

5.2.1. Cooperation between Home and Host NSAs during ongoing supervision

Issue: Cross border activities are sometimes inappropriately supervised due to a lack of cooperation between relevant supervisory authorities. The current obligations for NSAs to cooperate is already foreseen in the EIOPA Decision on Collaboration. However, there is no legal obligation for intensive cooperation between supervisory authorities during the ongoing supervision of insurers, which operate on a cross-border basis.

Recommendation by EIOPA: Introduce a legal requirement for the Home NSA to actively cooperate with Host NSA to assess whether insurers have a clear understanding of the risks they cover outside the Home Member State. Efficient cooperation and timely information exchange would improve policyholder protection by allowing more timely intervention when deemed necessary.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	More cooperation and information sharing allows for a more efficient supervision.
Insurers	No material impact as the information exchange is amongst the NSAs.	No material impact.
Supervisors	Extra effort and costs for the NSAs to be better informed on cross-border business as part of the outcome of the supervisory review process of the Home NSA.	NSAs would be better informed and able to act before serious issues occur.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve cooperation, consistency and effectiveness of supervision and ensure an improved level-	++

		playing field and prevent later failures. All this contributes to enhancing policyholder protection.	
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		The increase cost for the NSAs could be seen as a prevention for later actions. However, this not means that the extra cost every time will be effective and will prevent insurance failures.	+

Conclusion: This policy recommendation is cost effective, by adding legal requirement for the Home NSA to actively cooperate with the Host NSAs and to be better informed about cross-border activities. This would ensure that sufficient resources are dedicated by Home NSAs to the supervision of such cross-border activities. Effective collaboration information exchange can prevent later supervisory issues. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

5.2.2. Strengthening the framework for joint on-site inspection for cross-border supervision, under the binding mediation by EIOPA.

Issue: Currently, the possibility to conduct joint on-site inspections between Home and Host NSAs is mentioned in paragraphs 4.1.1.9 and 4.1.2.6 of the Decision on Collaboration. Therefore, such possibilities are only envisaged in non-binding tools, and are not much used, despite some attempts by Host NSAs[186]. Joint on-site inspections offer the possibility of stronger cooperation, possibly with the involvement of EIOPA in cases where there are strong concerns on the solvency position of insurers operating on a cross-border basis.

Recommendation by the French and Italian supervisory authorities: In cases of material non-compliance with capital requirements (including a likely breach of minimum capital requirements), the Host NSA should have the possibility to request to the Home NSA a joint on-site inspection where the conclusions are co-signed (i.e. they reflect a shared view of the Home and Host supervisors), with the possible participation of EIOPA. Where the Home supervisor disagrees with this request, or where disagreements occur on the conclusions to draw on the joint on-site inspection, supervisory authorities should have the possibility to refer the case to EIOPA, which would have a role of binding mediation.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	Strengthened cooperation between Home and Host supervisors would improve policyholder protection.
Insurers	No material impact. Insurers can already be subject to joint on-site inspection according to the Decision on Collaboration.	The joint assessment by Home and Host supervisory authorities provides more visibility for insurers on the remedial actions to be taken (if any) as a follow-up of the joint on-site inspection.
Supervisors	Extra effort and cost for the Home supervisor to cooperate with the Host supervisor.	Stronger coordination role to EIOPA. A joint on-site inspection would allow

[186] For instance, five of the six cross-border failures which occurred in France concerned the specific business of *assurance dommages-ouvrage*, where the bulk of the claims occurs, at the earliest, 10 years after the premium was paid. Based on this experience, the French and Italian supervisory authorities are of the view that joint on-site inspections could have facilitated the identification of issues and a common view of the situation of the insurers concerned.

	However, joint on-site inspection would could only be envisaged in case of material non-compliance with capital requirements.	a better understanding of the sources of weaknesses of the insurer concerned.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	Requests for joint on-site inspections would only be possible when there is a material concern on the solvency position of an insurer.	+
	Quality of supervision - protection against failures	This recommendation would enhance cooperation between Home and Host supervisors and would ensure a shared view on the situation of an insurer, which is already in material breach of its capital requirements. EIOPA's binding mediation role would ensure that (i) disagreements are settled in a consistent manner and (ii) there is no risk of abuse of request for joint on-site inspection by Host supervisors or of refusals by Home supervisors.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		Cooperation through joint on-site inspection has a cost for the supervisory authorities, but this is an effective manner to ensure that supervisory authorities, under the coordination by EIOPA, intensively cooperate in case of strong concerns on the solvency of an insurer.	+

Conclusion: This policy recommendation is cost effective, by introducing the possibility for the Host supervisor to request a joint on-site inspection only in cases of concerns of material non-compliance with capital requirements by an insurer. This recommendation has to be read in conjunction with Sub-section 4.1.4 (it would be possible to make such requests if the Host supervisor has access to minimum prudential information on a timely basis). EIOPA's binding mediation role would ensure that there is no abuse of requests for joint on-site inspections which would not be justified or on the contrary that the Home supervisor does not systematically rejects such requests even when they can be justified. Similarly, the possibility for EIOPA to settle disagreements on the conclusions to draw from an on-site inspection would ensure more consistency in cross-border supervision. All this contributes to policyholder protection. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic.

5.2.3. Enhanced mediation role for EIOPA in complex cross-border cases

Issue: Currently policyholders run higher risks when Home and Host NSAs disagree on how to address a cross-border issue. This is also the case when the NSAs concerned fail to reach a common view in the context of cooperation platforms[187]. Furthermore, there are no legal obligations to notify to EIOPA situations of deteriorating financial conditions or other emerging risks, including consumer protection risks, posed by an insurer carrying out cross-border activities

[187] A cooperation platform is established when relevant NSAs see the merit in strengthening cooperation in case of material cross-border business in order to enable a sound internal market in the EU. The platforms allow Home supervisors to make use of expertise and knowledge about local market specificities from Host supervisors.

Recommendation by EIOPA: The proper functioning of the cooperation platform could be further optimised by adding an explicit reference in the Solvency II Directive to EIOPA's power to issue a recommendation (in accordance with Art. 16 of EIOPA Regulation) in order to address disagreements in complex cross-border cases. Supervisory authorities concerned would be given two months to either comply with the recommendation or justify why they deviate from it. If EIOPA does not deem the justification appropriate, it shall make its recommendation public together with the proposed next steps.

Analysis of the recommendation:

	Costs (compared to "no change")	Benefits (compared to "no change")
Policyholders	No cost.	A supervisory recommendation from EIOPA is to the benefit of policyholders when adequately followed up by NSAs.
Insurers	No material impact, possible decrease of costs (more clarity due to the timely solution).	Clear supervisory recommendations and timeframes give guidance to NSAs and therefore for industry on supervisory expectations.
Supervisors	Less costs due to shorter timeline to find a solution for supervisory issues.	Clear supervisory recommendation give guidance to NSAs on supervisory actions to be taken.

		Impact of EIOPA's proposals (compared to "no change")	
Effectiveness	Long-term and green financing	No impact identified.	0
	Risk sensitivity and volatility	No impact identified.	0
	Proportionality	No impact identified.	0
	Quality of supervision - protection against failures	EIOPA's proposals would improve consistency and effectiveness of supervision and ensure end of the risks of non-action and consequently possible failures. All this contributes to enhancing policyholder protection.	++
	Financial stability	No impact identified.	0
	International competitiveness	No impact identified.	0
Efficiency (cost-effectiveness)		The solution proposed has limited cost for stakeholders but can improve quality of supervision of complex cross-border cases. However, there is no guarantee that EIOPA's recommendation is followed.	+

Conclusion: Timely and efficient solutions on the follow up on supervisory issues can prevent further escalation and higher risks for policyholders in case of non-action. The approach remains quite modest in terms of ambition, as EIOPA's recommendation may not be followed. On the other hand, going further in the balance of powers between NSAs and EIOPA would probably not get political support. Therefore, Option 2 of the impact assessment endorses EIOPA's advice on this topic which is a step in the direction towards more consistent supervision under the mediation role of EIOPA.

6. INCORPORATING A MACRO-PRUDENTIAL DIMENSION IN SOLVENCY II

As part of the problem of *limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector,* Option 2 – "make targeted amendments to prevent financial stability risks in the insurance sector" is part of the overall package of "preferred options" for the impact assessment. This option would ensure that new requirements to

prevent the potential build-up of systemic risks in the insurance sector are implemented in a proportionate manner**.** The aim of this section is to provide some background on the sources of systemic risk in insurance and further clarify what is embedded within the recommended option.

In EIOPA's view, systemic events in insurance could be generated in two ways:

- "direct" effect, originated by the failure of a systemically relevant insurer or the collective failure of several firms generating a cascade effect[188]. This systemic source is defined as "*entity-based*";
- "indirect" effect, in which possible externalities are enhanced by engagement in potentially systemic activities (*activity-based* sources), like involvement in certain products with greater potential to pose systemic risk or the existence of potentially dangerous interconnections, or by widespread common reactions of firms to exogenous shocks (*behaviour-based* source), like excessive risk-taking by insurers (e.g. "search for yield") or "excessive concentrations".

It is also widely acknowledged that the insurance sector can contribute to systemic risks, but that the traditional insurance activities are generally less systemically important than banking. A macro-prudential approach would be justified provided that it is tailored to insurance and implemented in a "proportionate" manner (so that it permits to tackle the sources of systemic risks which have been previously identified, without creating unnecessary costs for the insurance industry's capacity to invest long-term and provide long-term services to policyholders).

EIOPA has identified the following "operational" objectives that public authorities should pursue to ensure the ultimate objective, i.e. financial stability:

- Ensure sufficient loss absorbency capacity and reserving;
- Discourage excessive involvement in certain products and activities;
- Discourage excessive levels of direct and indirect exposure concentrations;
- Limit pro-cyclicality;
- Discourage risky behaviour.

Solvency II already incorporates several tools with indirect macro-prudential impact, which seek to address the risk of collective behaviour by insurers that may exacerbate market price movements. In particular, the symmetric adjustment in the equity risk module, the volatility adjustment (VA), the matching adjustment (MA) contribute to limit pro-cyclical behaviours which may arise from the pure application of the market consistent valuation during periods of short term volatility of financial markets. In addition, the extension of the recovery period in case of non-compliance with the SCR already permits — under exceptional circumstances — to extend (from 6 months to up to 7 years) the regulatory period that allows insurers in breach of their SCR to take the necessary measures to restore their financial soundness (recovery). Finally, Solvency II allows public authorities to prohibit or restrict certain types of financial activities, although this is possible when insurers are in breach of the quantitative solvency requirements.

Existing Solvency tools or powers with direct macro-prudential impact	**Sources of systemic risk addressed**	**Objectives**
• Symmetric adjustment for equity risk	• Collective behaviour by undertakings that	• Limit pro-cyclicality

[188] The disorderly failure of large insurers could cause disruption to the global financial system, due to their size, the complexity of their investment and underwriting activities, and/ or their interconnectedness with financial markets.

• Volatility adjustment • Matching adjustment[189] • Extension of the recovery period[190]	may exacerbate market price movements	
• Supervisory power to prohibit or restrict certain types of financial activities when there is breach of regulatory capital requirements	• Involvement in certain activities or products with greater potential to pose systemic risk • Excessive risk-taking by insurance undertakings	• Discouraging excessive involvement in certain products and activities • Discourage risky behaviours

As some of the sources of systemic risk in insurance cannot be sufficiently prevented with the existing tools, the recommended Option 2 would include specific tools to further limit the build-up of risks for the financial stability and provide supervisors with additional information to act before such risks materialise.

As part of the recommended policy Option 2, insurance companies would be required to integrate macro-prudential consideration in their investment and risk-management activities. In particular, insurance companies would be required to assess the macro-economic risks (such as credit cycle downturns or reduced market liquidity) which may affect their investment decisions and operations (i.e. the application of the "prudent person principle") and subsequently reflect those risks into the forward-looking evaluation of their solvency situation (i.e. ORSA).

By expanding the "prudent person principle" [191] to account for macro-prudential considerations, insurance companies would be incentivised to take account of the potential behaviour of other market participants or excessive concentrations at sector level when they analyse the diversification and liquidity of their investment portfolios. Supervisors would thus gain additional information and insights to discourage potential excessive levels of exposure concentration or involvement in certain activities.

When it comes to the own risk and solvency assessment (ORSA)[192], supervisors would be able to aggregate the (expanded) information received from single insurers and detect: i) similar/different approaches in managing specific risks by insurers; ii) common elements that

[189] Under Solvency II, insurers are required to calculate the value of their liabilities using a benchmark risk-free interest rate curve derived by EIOPA. The matching adjustment is an upward adjustment to the risk-free rate where insurers hold certain long-term assets with cash-flows that match the cash-flows of liabilities. It reflects the fact that long-term "buy-and-hold" investors are not exposed to spread movements in the same way that short-term traders of such assets are. Therefore, like the volatility adjustment, the matching adjustment mitigates the impact on insurers' solvency position of short-term volatility in bond spreads.

[190] When an insurer does not comply with its capital requirements, it is given between six and nine months to recover. The extension of the recovery period is a provision allowing supervisory authorities to extend that timeframe up to seven years when EIOPA declares an exception adverse situation (conditions are further specified in the legislation). The underlying rationale is to ensure that insurers do not behave procyclically (e.g. by selling the same "risky" assets at the same time) when a financial crisis leads to a material deterioration of several insurance companies in a given national market. Therefore, this provision aims at ensuring that insurers do not amplify the impact of an exogenous macroeconomic shock.

[191] The "prudent person principle" as set out in the Solvency II Directive provides that insurers shall only invest in assets and instruments whose risks the company concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs.

[192] The "own risk and solvency assessment" (ORSA) is an important part of insurers' risk management process. It aims at supporting insurers to get a holistic view of their risk profile and to understand how all risks affect the future solvency situation.

may result in common behaviours across the insurance market. Insurance companies, in turn, would benefit from the input received from supervisors and be able to further develop the macro-prudential perspective into subsequent ORSA exercises.

In addition, insurance companies would be required to strengthen liquidity risk management planning and reporting processes, while supervisors would be able to intervene whenever any resulting vulnerability – for instance liquidity shortages for some maturities that may affect the capacity to pay-out claims or benefits to policyholders in a timely manner – are not appropriately addressed by insurers. This liquidity framework would be designed in such a way that it ensures that supervisory intervention is a last-resort measure and that its terms would be kept flexible and adaptable to specific situations.

Moreover, supervisors would be equipped with the power to temporarily freeze redemption rights in exceptional circumstances, notably to restore liquidity or avoid mass surrender behaviours, provided that those freezes are linked to (or preceded by) prohibitions of variable remunerations, bonuses and dividend distributions for shareholders.

In fact, more generally, supervisors would be granted the power to restrict or suspend dividend distributions and variable remunerations at individual level in exceptional situations (e.g. during a crisis). This provision would be accompanied by adequate safeguards to ensure that the measure is only applied when the solvency position is substantially deteriorated (or has a prospect of being substantially deteriorated) and may result in a likely non-compliance with the (stated) risk-tolerance limits. Such an approach would give more legal certainty to dividend distribution policies during crisis situations affecting the totality or large part of the insurance market (e.g. the COVID-19 crisis). Supervisors would not be entitled to impose "blanket bans" on dividends in absence of risk-based criteria. They would remain in any case free to recommend prudent capital management approaches at market-level and continue to operate within the ranges of powers given by their legal mandate.

Finally, the prudential rules of Solvency II on the calculation of the counterparty default risk under the standard formula would be amended so that banking-type loan origination activities by insurers would not be subject to more preferential treatment than in the banking sector. This amendment would avoid possible risks of regulatory arbitrage when it comes to banking-like activities performed by insurers.

New macro-prudential tools (Option 2)	**Sources of systemic risk prevented**	**Objectives**
• Requirement for (re)insurers to take into account how the macroeconomic developments interact with their **Own risk and solvency assessment (ORSA)**	• Excessive concentrations • Deterioration of the solvency position leading to failure of a systemically important insurer or collective failures of non-systemically important institutions as a result of exposures to common shocks	• Discourage excessive levels of direct and indirect exposure concentrations • Ensure sufficient loss absorbency capacity and reserving
• Requirement for (re)insurers to take into account how the macroeconomic developments can affect their investment activities (i.e. the	• Excessive concentrations • Involvement in certain activities or products with greater potential to pose	• Discourage excessive levels of direct and indirect exposure concentrations

application of the **"prudent person principle"**), allowing supervisors to assess how (re)insurers' activities may affect market drivers;	systemic risk	• Discourage excessive involvement in certain products and activities
• Requirement for (re) insurers to strengthen **liquidity risk management planning and reporting** • Possibility for supervisors to intervene whenever any resulting liquidity vulnerabilities are not appropriately addressed by (re) insurers • As a last resort measure, possibility for supervisors to **temporarily freeze redemption options** on life insurance policies to avoid "insurance run"	• Involvement in certain activities or products with greater potential to pose systemic risk • Excessive concentrations • Potentially dangerous interconnection • Collective behaviour by undertakings that may exacerbate market price movements (e.g. fire-sale or herding behaviour)	• Discourage excessive levels of direct and indirect exposure concentrations • Discourage excessive involvement in certain products and activities • Limit pro-cyclicality
• Prudential rules are amended so that banking-type loan origination activities by insurers are not subject to more preferential treatment than in the banking sector	• Involvement in certain activities or products with greater potential to pose systemic risk	• Discourage risky behaviour • Ensuring sufficient loss absorbency capacity and reserving • Discourage excessive involvement in certain products and activities
• In exceptional situations, **possibility for supervisors to restrict or suspend dividend distributions and variable remunerations on a case-by-case basis**	• Deterioration of the solvency position leading to failure of a systemically important insurer or collective failures of non-systemically important institutions as a result of exposures to common shocks	• Ensuring sufficient loss absorbency capacity and reserving

Analysis of the recommendation:

	Costs (compared to "no change")	**Benefits (compared to "no change")**
Policyholders	Supervisory powers to limit	Supervisory powers to limit surrender

	surrender options on life insurance contracts may be harmful to policyholders in the short term, but also prevent losses in the longer term.	options would reduce financial instability risks and possible spill-over effects on the real economy (which could affect policyholders as taxpayers).
Insurers	Additional regulatory costs in terms of risk management and reporting systems; possible costs during exceptional crisis situations because of dividend restrictions.	Limited impact on their capacity to compete at international level.
Supervisors	No material cost.	Enhanced powers in crisis situations (i.e. dividends restrictions); sufficient margin of discretion in exercising macro-prudential supervision.

		Impact of the recommended policy option (compared to "no change")	
Effectiveness	Long-term and green financing	The integration of macro-prudential considerations within investment policies of insurers may refrain some types of long-term financing (e.g. equity) when supervisors detect possible sources of systemic risks.	-
	Risk sensitivity	Option 2 would preserve the risk-based nature of the framework, including on dividend distribution policies during crisis situations.	+
	Volatility	No impact identified.	0
	Proportionality	Option 2 would not generate particular costs for insurers in terms of capitalisation, while it would require targeted adaptations to risk management and investment policies.	+/-
	Quality of supervision - protection against failures	Option 2 would grant supervisors with a common set of macro-prudential tools to prevent the failure of large insurers, but it would keep the risk of supervisors acting independently or taking uncoordinated decisions.	--
	Financial stability	Option 2 would determine a tangible improvement of the ability of supervisors to address collective behaviours\activities that may have indirect effects on the stability of the insurance sector.	++
	International competitiveness	Although Option 2 would be largely in line with the international framework for systemic risk, the power for supervisors to restrict dividend distributions could increase financing costs for European insurers compared to non-EU ones, but the use of this power would be subject to criteria, contributing to legal certainty.	-
Efficiency (cost-effectiveness)		Overall limited costs for the insurance industry, while effective for supervisors to meet the macro-prudential objectives set by EIOPA.	++

Conclusion: This policy recommendation is cost effective. It allows reinforcing the capacity of the insurance sector to prevent the origination or amplification of risks for the financial stability, in line with the macro-prudential objectives set by EIOPA, without creating substantial costs for the insurance sector.

ANNEX 9: OTHER INITIATIVES THAT WILL HAVE A MATERIAL IMPACT ON THE INSURANCE SECTOR

At this stage, the Commission is pursuing several initiatives to increase private financing of the transition to a carbon-neutral economy and to ensure that climate and environmental risks are managed by the financial system. The following initiatives will have a significant impact on the insurance sector.

- Directive 2014/95/EU ("non-financial reporting directive" or "NFRD") requires sustainability-related non-financial reporting by companies, including insurers, with more than 500 employees. That Directive and in particular the scope of the requirement on and the modalities for non-financial disclosures are being reviewed.
- Regulation (EU) 2020/852 ("taxonomy regulation") creates a common language for the identification of sustainable activities. An on-going initiative aims to develop technical screening criteria for the taxonomy in a delegated act. It is probable that the delegated act will contain sectoral criteria for underwriting by non-life insurance and reinsurance companies.
- Furthermore, the taxonomy regulation also requires the disclosure of key performance indicators on taxonomy-alignment by any company in the NFRD scope. The specific key performance indicators will be set out in a delegated act that is being prepared as a separate initiative.
- The Commission is preparing a renewed sustainable finance strategy with a broad scope and possible actions concerning all financial services sectors. Among others, the strategy will aim to strengthen the foundations for sustainable investments and to fully integrate and manage sustainability considerations into the financial system. The review of Solvency II will be one of the elements to achieve the objectives of the renewed sustainable finance strategy.
- As announced in the European Green Deal communication, the Commission is pursuing an initiative to embed sustainability into the corporate governance framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects.
- The Commission is also working on an initiative to align EU law with international standards for prudential rules of the banking sector. That initiative is also looking at the integration of sustainability risks into banking prudential rules.