

## Consultation Paper No. 64

# Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Extension of the Recovery Period

*CEIOPS welcomes comments from interested parties on the following Consultation Paper.*

*Please send your comments to CEIOPS by email ([secretariat@ceiops.eu](mailto:secretariat@ceiops.eu)) by 11 December 2009 12:00 CET, indicating the reference "CEIOPS-CP-64/09".*

*Please note that comments submitted after the deadline or not submitted in the provided template format **cannot** be processed.*

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# 1. Introduction

- 1.1. In its letter of 19 July 2007, the European Commission requested CEIOPS to provide final, fully consulted advice on Level 2 implementing measures by October 2009 and recommended CEIOPS to develop Level 3 guidance on certain areas to foster supervisory convergence. On 12 June 2009 the European Commission sent a letter with further guidance regarding the Solvency II project, including the list of implementing measures and timetable until implementation.
- 1.2. This Paper aims at providing advice for Level 2 measures with regard to the extension of the recovery period by the supervisory authority, in the event of an exceptional fall in financial markets, in cases where the Solvency Capital Requirement of an undertaking is no longer complied with, as required in Article 141 in conjunction with Article 136 of the Solvency II Level 1 text<sup>1</sup> ("Level 1 text").
- 1.3. The recent financial crisis has shown that a major slump in financial markets is not an unrealistic scenario. Undertakings and supervisory authorities alike must be able to respond effectively to such circumstances, ensuring policyholder protection is maintained whilst avoiding short term actions that may fuel the market downturn and endanger wider market stability which ultimately would be detrimental to policyholders' interests as well.
- 1.4. For this purpose a provision was introduced into the Level 1 text in Article 136 that allows supervisory authorities, in the event of an exceptional fall in financial markets, to extend the normal period of time of six or nine months at most that undertakings have to remedy a breach of the Solvency Capital Requirement (SCR).
- 1.5. The purpose of this Paper is to provide advice on the Level 2 implementing measures in connection with Article 136(3a) that *shall* be adopted under Article 141 of the level 1 text. Specifically, this refers to factors to be taken into account when supervisors consider extending the period in which an undertaking can restore its SCR following a breach during an exceptional fall in financial markets. It also includes CEIOPS' advice on the maximum period of time, expressed in total number of months, which supervisors should be able to allow under Article 136, for an undertaking to re-comply with the SCR.
- 1.6. The Paper also touches upon how Article 136(3a) is to be interpreted in CEIOPS' view and the questions that arise in the application of the article. It will, however, be left to Level 3 guidance to establish how the provision should be applied in practice in order to achieve a sufficient level of harmonisation.
- 1.7. Any implementing measures that *may* be adopted in accordance with Article 141, second subparagraph, in relation to laying down specifications with respect to the recovery plan referred to in Article 136(2) and the finance scheme referred to in Article 137(2) and 139 are outside the scope of this Paper as the European Commission will only contemplate the introduction of such Level 2 implementing measures at a later date, if it should prove necessary in order to enhance convergence. CEIOPS will develop Level 3 guidance to ensure an adequate level of harmonisation.

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<sup>1</sup> [Text adopted by the European Parliament on 22 April 2009,   
http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20090422+SIT-03+DOC+WORD+V0//EN&language=EN](http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20090422+SIT-03+DOC+WORD+V0//EN&language=EN).

## 2. Extract from the Level 1 text

- 2.1. The supervisory power to extend the normal period of time that undertakings are granted according to the Level 1 text follows from Article 136 which states:

*Article 136: Non-Compliance with the Solvency Capital Requirement*

1. *Insurance and reinsurance undertakings shall immediately inform the supervisory authority as soon as they observe that the Solvency Capital Requirement is no longer complied with, or where there is a risk of non-compliance in the following three months.*
2. *Within two months from the observation of non-compliance with the Solvency Capital Requirement the insurance or reinsurance undertaking concerned shall submit a realistic recovery plan for approval by the supervisory authority.*
3. *The supervisory authority shall require the insurance or reinsurance undertaking concerned to take the necessary measures to achieve, within six months from the observation of non-compliance with the Solvency Capital Requirement, the re-establishment of the level of eligible own funds covering the Solvency Capital Requirement or the reduction of its risk profile to ensure compliance with the Solvency Capital Requirement.*

*The supervisory authority may, if appropriate, extend that period by three months.*

- 3a. *In the event of an exceptional fall in financial markets the supervisory authority may extend the period set out in the second sub-paragraph of paragraph 3 by an appropriate period of time taking into account all relevant factors.*

*The insurance or reinsurance undertaking concerned shall submit every 3 months a progress report to its supervisory authority setting out the measures taken and the progress made to re-establish the level of eligible own funds covering the Solvency Capital Requirement or the reduction of the risk profile to ensure compliance with the Solvency Capital Requirement.*

*The extension referred to in subparagraph 1 shall be withdrawn if that progress report shows that there was no significant progress in achieving the re-establishment of the level of eligible own funds covering the Solvency Capital Requirement or the reduction of its risk profile to ensure compliance with the Solvency Capital Requirement between the date of the observation of non-compliance of the Solvency Capital Requirement and the date of the submission of the progress report.*

4. *In exceptional circumstances, if the supervisory authority is of the opinion that the financial situation of the undertaking concerned will deteriorate further, it may also restrict or prohibit the free disposal of the assets of that undertaking. That supervisory authority shall inform the supervisory authorities of the host Member States of any measures it has taken. Those authorities shall, at the request of the supervisory authority of the home Member State, take the same measures. The supervisory authority of the home Member State shall designate the assets to be covered by such measures*

- 2.2. The scope of the Level 2 implementing measures on Article 136(3a) is determined by Article 141 which states:

*Article 141: Implementing measures*

*The Commission shall adopt implementing measures specifying the factors to be taken into account in accordance with Article 136(3a) including the maximum appropriate period of time, expressed in total number of months, which shall be the same for all insurance and reinsurance undertakings as referred to in the first sub-paragraph of Article 136(3a).*

*Where it is necessary to enhance convergence, the Commission may adopt implementing measures laying down further specifications with respect to the recovery plan referred to in Article 136(2) and the finance scheme referred to in Articles 137(2) and 139, taking due care to avoid pro-cyclical effects.*

*Those measures designed to amend non-essential elements of this Directive, by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 304 (3).*

- 2.3. Recital 35a gives the background for Article 136(4):

*In order to mitigate undue potential pro-cyclical effects of the financial system and avoid that insurance and reinsurance undertakings are unduly forced to raise additional capital or sell their investments as a result of unsustained adverse movements in financial markets, the market risk module of the standard formula for the Solvency Capital Requirement should include a symmetric adjustment mechanism with respect to changes in the level of equity prices. In addition, in the event of exceptional falls in financial markets, and where that symmetric adjustment mechanism is not sufficient to enable insurance and reinsurance undertakings to fulfil their Solvency Capital Requirement, provision should be made to allow supervisory authorities to extend the time period within which insurance and reinsurance undertakings have to re-establish the level of eligible own funds covering the Solvency Capital Requirements.*

## 3. Advice

### 3.1. Non-compliance with the SCR during periods of exceptional falls in financial markets

#### Explanatory text

- 3.1. The term “exceptional fall” as referred to in Article 136(3a) is not defined in the Level 1 text. It has to be interpreted in view of the whole purpose of the provision which is to provide supervisory authorities with flexibility in difficult financial market situations so that they do not have to take supervisory measures that could have a procyclical effect. Pro-cyclicality in this context refers to the effect on the economic, financial or insurance cycle as a consequence of the actions of regulation. It specifically describes a situation where the overall impact of actions caused by regulation increases the severity of these cycles.
- 3.2. An exceptional fall in financial markets has to be distinguished from smaller, common market falls which characterise the fluctuations of normal market activity and which is not a situation where Article 136(3a) applies. Undertakings should be prepared and have properly designed plans that ensure they do not breach the SCR when the economic cycle is in a depression: According to Article 44(2) of the Level 1 text an undertaking is required to have in place processes which enable it to properly identify and measure the risks it faces in the short and the long term. This includes identifying possible events or future changes in economic conditions that could have unfavourable effects on the undertaking’s overall financial standing.
- 3.3. In order to be considered “exceptional” the fall in financial markets would have to be unforeseen, sharp and steep. Ordinary downturns (downturns that occur at more or less regular intervals as part of the economic cycle), even if they are somewhat more severe and longer lasting than usual, would not suffice to trigger the supervisory power of granting extended recovery periods.
- 3.4. The term “financial markets” used in the Level 1 text is also not defined. It can be divided into different subcategories such as capital markets (i.e. stock and bond markets), commodity markets, derivatives markets, insurance and money markets and foreign exchange markets. The Level 1 text could be read to refer to “any part of the financial markets” or “financial markets in general” or to “the financial markets” i.e. the global financial market situation. In view of the aim of Article 136(3a) to provide sufficient flexibility in order to avoid procyclical effects, CEIOPS holds that the term “financial markets” does not necessarily refer to the global financial markets but could apply to subcategories of financial markets if a major unforeseen, sharp and steep fall seriously affects the financial situation of a number of undertakings.
- 3.5. Exceptional falls in financial markets will, by their nature, arise in unpredictable ways and with unpredictable consequences. While CEIOPS recognises that to maintain a level playing field it is important to achieve a degree of convergence in the application of extended recovery periods and in particular in the assessment of the preconditions for granting an extension, it would defeat the aim of Article 136(3a) if an exceptional fall in financial markets were too narrowly defined, forcing supervisors to require short-term recovery plans even if this resulted in procyclical effects.

- 3.6. CEIOPS therefore does not consider it appropriate to prescribe in detail what would constitute a trigger event or to introduce thresholds for “exceptional” falls in financial markets. CEIOPS rather proposes to establish a process through which it is consulted before a supervisory authority decides on any application of Article 136(3a) and where supervisory authorities rapidly arrive at a common understanding whether an “exceptional fall in financial markets” has occurred and when it is over<sup>2</sup>.
- 3.7. Once it has been determined that an “exceptional fall in financial markets” is taking place, national supervisors will have the possibility to grant extensions to the period for re-establishing compliance with the SCR within the maximum limit set out below.
- 3.8. There should be continuous monitoring of whether the “exceptional fall in financial markets” is still taking place or not. Once this “exceptional fall” is deemed to be over, no further extensions may be granted.
- 3.9. A recovery does not require that “normal” levels are reached again. An exceptional fall in financial markets would be over if the markets recovered to what is considered an ordinary downturn in the financial markets cycle.

## 3.2. Maximum extension permissible

### Explanatory text

- 3.10. The Level 1 text requires that the maximum extension is measured in total number of months and specified by Level 2 implementing measures.
- 3.11. Choosing a long maximum recovery period does not mean that this is the time undertakings will be given as a rule. The maximum should not be the norm but may be necessary in individual circumstances. The maximum extension is an upper limit and does not preclude the supervisor from requiring an undertaking to restore a sound financial position within a shorter timeframe if the potential effects on market stability and the specific situation of the undertaking do not suggest that a longer period should be granted. In circumstances where it is possible for an undertaking to achieve rapid re-compliance with the SCR without concerns about adverse market effects, the maximum extension is unlikely to be appropriate.
- 3.12. The issue of the extension of the recovery period in the event of an exceptional fall in financial markets is subject to an Impact Assessment, as required by the EC. This is set out in more detail in the Annex. Four options were set for CEIOPS to consider as regards the maximum time period allowed. These are:

Option 1	15 months – i.e. 6+3 (in normal market circumstances) + another 6 months (in the event of exceptional market falls)
Option 2	24 months – i.e. 6+3 (in normal market circumstances) + another 15 months (in the event of exceptional market falls)

<sup>2</sup> The design of the mechanism through which this common understanding is to be achieved is outside the scope of this Paper and will be subject to future CEIOPS work. This should take into account, if necessary, the changes in the legal structure and competences CEIOPS (EIOPA) may experience when the proposals from the de Larosière report and European Commission draft regulation are implemented.

Option 3	36 months – i.e. 6+3 (in normal market circumstances) + another 27 months (in the event of exceptional market falls)
Option 4	60 months – i.e. 6+3 months (in normal market circumstances) + another 51 months (in the event of exceptional market falls)

- 3.13. CEIOPS has considered the arguments for and against a short and a long maximum extension period and assessed them with a view to their impact on stakeholders and their suitability in meeting the objectives specified by the European Commission.
- 3.14. During exceptional market falls a short extension may place too hard a requirement on undertakings and be harmful in that it may result in further destabilising effects on financial markets (pro-cyclicality). If many undertakings are forced to take similar actions in a short timeframe this may negatively impact the interests of policyholders. In this regard, foreseeable management actions to the need to re-comply with the SCR over an insufficient timeframe may be contrary to the interests of policyholders, and could include actions to de-risk such as:
- a) a number of undertakings selling assets at the same time in order to minimise applicable capital charges and reduce the SCR, increasing financial market falls;
  - b) a number of undertakings being forced to raise capital at the same time from sources already under stress, which results in expensive debt raising with high interest payments over a long period which is unlikely to be in the best interests of policyholders; and
  - c) a number of undertakings purchasing reinsurance cover in an 'expensive' market, as reinsurance undertakings are also likely to be adversely affected, and expensive short-term cover is unlikely to be in the best interests of policyholders.
- 3.15. Mandating re-compliance with the SCR in a short timeframe may therefore lead to adverse pro-cyclical effects and market instability and may not be realistic. It is worth noting that if short terms action exacerbates market problems and continued steep falls occur this puts greater pressure on all insurance undertakings' solvency and thus indirectly impacts policyholders.
- 3.16. Also the current financial crisis shows that recovery from a plunge in financial markets may take some time. The longer the crisis the more undertakings are potentially affected. A short maximum extension period could thus still require a major number of undertakings to take actions in a situation where economic conditions are severely stressed.
- 3.17. A longer maximum extension would provide supervisors with the flexibility to avoid responding to non-compliance with the SCR in a way which results in adverse impacts and undermines market stability. Undertakings selling assets into a low and/or falling market is not a desirable outcome for policyholders.
- 3.18. From this it might be thought that the longer the possible maximum extension the better, since a longer timeframe also means more flexibility for the supervisor. However, this should not mean that the time frame for recovery should be extended to the point in time where financial markets have

rebounded after an exceptional fall. Undertakings are not supposed to wait for an improvement of the market situation, but are required to demonstrate significant progress in their efforts to re-establish compliance with the SCR.

- 3.19. Further, a very long maximum recovery period could be seen as “de-valuing” the SCR, as under certain exceptional circumstances a long lasting breach of regulatory requirements is permitted – although the undertaking is required to prove suitable effort and success in remedying the situation. The impression that the SCR is only relevant under “normal circumstances” whereas in difficult financial conditions sound capital requirements are in effect suspended until the situation is back to normal, should be avoided.
- 3.20. Also due consideration should be given to the fact that a reduced maximum period will enhance harmonisation of supervisory practices and limit the use of national discretion in setting the length of extension periods in individual cases.
- 3.21. It could also be argued that since the SCR is based on a one-year horizon, the maximum extension available should not be significantly longer than a year, as non-coverage of the SCR may significantly increase the risk of default beyond this horizon. However this argument does not take into account that the decision on the extension is to be considered only when there is an exceptional fall in financial markets, i.e. in exceptional circumstances.
- 3.22. Therefore the maximum extension period should not be as long as possible but be limited to what is considered strictly necessary to provide sufficient flexibility for the recovery measures of a larger number of undertakings to be spread out so as to avoid significant adverse effects on an already stressed market situation.
- 3.23. CEIOPS is of the opinion that, as the recovery period should be neither very short nor very long, the middle ground between options 2 and 3 provides the best solution for the maximum extension period.

#### **CEIOPS’ advice**

3.24. The maximum extension available under Article 136(3a) shall be set at 21 months in the event of exceptional falls in financial markets<sup>3</sup>.

### **3.3. Specification of factors to be taken into account**

#### **Explanatory text**

- 3.25. In the event of an exceptional fall in financial markets supervisory authorities may decide to extend the time available to an undertaking for re-establishing compliance with the SCR, which is normally six months from the observation of the non-compliance (with an additional three months if appropriate), by an appropriate period of time.
- 3.26. An extension would only be granted following an explicit request by the undertaking concerned.
- 3.27. The decision to permit an extension as well as the duration of any extension is at the discretion of the supervisory authority. In using this discretion the Level

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<sup>3</sup> Resulting in a maximum period of up to 30 months (i.e. 6+3+21 months)  
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1 text requires the supervisory authority to take all relevant factors into account.

- 3.28. The period of time for which supervisory authorities can extend the normal recovery period is limited. The maximum possible timeframe for the extension according to Article 136(3a) will be established on Level 2. This maximum possible timeframe is the same for all (re)insurance undertakings. However, the length of the extension for individual undertakings in the same trigger event will vary according to the specific relevant factors to be taken into account.
- 3.29. Supervisory authorities should give proper consideration to whether an extension of time to re-establish compliance with the SCR is an adequate measure, considering the position of the undertaking and potential consequences of requiring short-term rectification. Whether an extension should be permitted, and the length of any extension, should be determined having regard to the severity of the exceptional fall in financial markets experienced, the means available to re-comply with the SCR in those circumstances and the best interests of policyholders.
- 3.30. While it is no precondition for granting the extension that the "exceptional fall in financial markets" is the cause of an undertaking's non-compliance with the SCR, an undertaking would have to show that and how the "exceptional fall" seriously affected its ability to re-establish coverage of the SCR as these are considerations the supervisory authority has to take into account in deciding whether an extension is in order and what is its adequate duration.
- 3.31. Article 141 requires the Commission to specify the factors to be taken into account in accordance with Article 136(3a). This does however not necessarily mean that Level 2 has to provide a comprehensive list of all relevant factors.
- 3.32. Factors to consider should reflect all circumstances associated with each individual case. Decisions on whether to grant an extension need to be made on a case-by-case basis using the relevant factors.
- 3.33. Prescription at Level 2 on this part of the Directive through a definitive, closed list of factors may therefore inhibit supervisors in taking account of all relevant factors and in assessing cases on their specific merits; in order to avoid any such barriers it may therefore be expedient to keep the list of factors open to admit the possibility of additional relevant factors.
- 3.34. On the other hand CEIOPS is aware that the level playing field and European harmonisation in the way the exceptional supervisory powers bestowed by Article 136(3a) are used may be better served with a comprehensive list of relevant factors.
- 3.35. A compromise solution could be to leave the list open on Level 2 and to prescribe factors that cannot be taken into account in order to limit supervisory authorities' scope for using Article 136(3a) and to provide for further harmonisation of the open list through Level 3 guidance.
- 3.36. Further it should be acknowledged that the relevance and weight given to factors will depend on the particular circumstances of the situation. So there can be no "formula" as to how the supervisor arrives at the appropriate timeframe for any extension. However, CEIOPS may seek, through Level 3 guidance, to come to a common understanding with regard to the relative importance of the different factors identified, for determining whether an extension should be granted, and its adequate duration.

- 3.37. Any extension granted needs to balance the policyholder protection objective and the need to ensure market stability through avoidance of adverse procyclical effects that may result from regulatory intervention forcing similar actions to be taken by a number of undertakings in a short period of time. This approach will require a high degree of communication between supervisory authorities as experience is gathered and shared between supervisory authorities, the degree of harmonisation will be higher, leading to a more effective and suitable consistency between supervisory actions.
- 3.38. In CEIOPS' view the factors to be taken into account can be external (independent of the undertaking) as well as internal (entity-specific). While external factors play a major role in evaluating potential procyclical effects, the individual situation of an undertaking is also important, in particular for the assessment of the duration of the extension period. CEIOPS considers that the relevant factors should include the following:

**External Factors:**

- a) Financial market stability (including systemic risk), in particular the procyclical impact of distressed sales of assets on the financial markets;

Supervisors should consider the possible effects on the stability of severely stressed financial markets if a number of undertakings that are having difficulty meeting their SCR seek to remedy this by de-risking or raising capital via the financial markets. This is necessary in order to establish a general idea as to how long recovery periods need to be under specific circumstances, so these additional demands on financial markets do not happen simultaneously in a way that creates de-stabilising effects. Avoiding the procyclical effect of distressed sales of assets on financial markets is one of the main reasons why the Level 1 text provides for the supervisory power to extend the recovery period. However, in assessing how this factor affects individual undertakings, supervisors need to consider the scale of such sales for the undertaking concerned and other available options the undertaking has in order to close the gap between the SCR and the level of own funds.

- b) Ability of financial markets<sup>4</sup> to provide extra capital at a reasonable price;

Where undertakings could increase their level of own funds to the necessary degree by raising new capital on financial markets the duration of any extension granted would potentially be shorter.

- c) Availability in financial markets of financial mitigation instruments (e.g. hedges) at a reasonable price;

Undertakings have more than one option when they seek to re-establish compliance with the SCR. A way to close the gap between the SCR and the level of own funds would be to take measures to reduce the SCR through enhanced financial mitigation instruments. How feasible an option this is, depends not only on the availability of such instruments in the financial markets but also on the ability of the undertaking to manage, monitor and control the instruments. When this is an available and adequate means, this option would potentially reduce any extension being granted.

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<sup>4</sup> In case there is government support available on account of a severe crisis situation this would be taken into account as well.

- d) Capacity of the reinsurance market to provide reinsurance cover at a reasonable price;

Undertakings in breach of the SCR would be expected to consider reducing their risk profile through the use of reinsurance arrangements they are able to manage, monitor and control. When this is an adequate and available means to re-establish compliance with the SCR, this would potentially reduce any extension period.

### **Internal Factors:**

- a) The causes leading to the non-compliance with the SCR;

Supervisors have to consider the causes leading to non-compliance with the SCR. If factors, other than factors arising from the exceptional fall in financial markets or consequences of this fall, have played a significant role in the non-compliance, there is less reason to extend the recovery period beyond what is strictly necessary to avoid a negative impact on financial stability.

- b) Degree of non-compliance with the SCR;

The nearer the level of own funds has decreased towards the MCR the more urgent is the need for the undertaking to improve its solvency position. How fast the solvency position is deteriorating and whether there is a risk of the undertaking becoming insolvent, also needs to be considered.

- c) The composition of own funds held by the undertaking;

Own funds are categorised into tiers. This tier system may restrict an undertaking's ability to solve the situation quickly. While it may be easier to raise tier 3 capital than higher level capital, an undertaking may need additional tier 1 or 2 capital to comply with the SCR.

- d) The composition of the undertaking's assets;

The assets of the undertaking are worth considering, as the undertaking could have a large stake in assets that would affect the market adversely if they were to be sold. Also the undertaking may be exposed to other risks via its assets. The effect of the crisis on the undertaking's asset portfolio is relevant in that in some cases undertakings may be able to get rid of assets more easily. On the other hand the quality of the assets held could be below average or more concentrated, thus increasing the risk to the undertaking independently from temporary market fluctuations.

- e) Nature and duration of technical provisions and other liabilities;

Where relevant, supervisors should consider the nature and duration of the undertaking's liabilities from an ALM point of view. It could be appropriate to give a longer extension period to undertakings whose liabilities have a longer duration.

- f) Solutions effectively available to the undertaking;

While some solutions may generally help to improve the solvency position of an undertaking, this may not provide an adequate solution in individual cases as the costs are disproportionate to the benefits. Also other decisions taken by the undertaking in the past could limit its ability to fall back on certain solutions for solving its solvency problems. Seriously limited options

for remedial actions could lead supervisors to grant a longer extension period.

- g) Potential availability of support from other group entities (if applicable);

Where other undertakings in the group are in a position to help an undertaking in financial difficulties this is a possible way out of the situation. Where there are such remedies for the undertaking this potentially reduces the necessary recovery period.

- h) The size or significance of the undertaking relative to the market, i.e. the impact on the market and on policyholders if the undertaking were to experience severe financial problems;

Since the rationale of Article 136(3a) is not to provide undertakings with a sufficiently long timeframe for recovery but to avoid negative effects for the insurance market in particular or financial markets in general, supervisors do not have to grant an extension if neither the interests of policyholders and beneficiaries nor the insurance market as such would be materially affected<sup>5</sup>.

- i) Steps taken by the undertaking to limit the outflow of capital and the deterioration of its solvency situation;

Undertakings cannot expect to be granted extensions of the recovery period if they choose not to use the measures available to them to ameliorate their situation. Failing to make use of possible restrictions on payments of dividends or coupons/principal on hybrid debt for example or writing (additional) new business in spite of material SCR problems could lead supervisors to refuse an extension.

### 3.39. Factors not to be taken into account:

- The point in time when normal conditions are expected to be re-established;

While supervisors will take into account how long they expect the exceptional fall in financial markets to last in order not to grant longer timeframes than are necessary to avoid procyclical effects, extension periods should not be chosen with a view to allowing undertakings to "sit out" a financial crisis. So the expected duration of the exceptional fall would not provide the minimum extension period. As the requirement to demonstrate significant progress towards re-establishing compliance with the SCR on a regular basis shows, undertakings need to take active steps to improve their solvency situation.

- How much time the undertaking needs to resolve the breach of the SCR without negative economic effects on its standing;

The power to grant extension periods is vested in supervisors in order to provide them with the necessary flexibility not to have to take decisions they consider would have significant negative effects for the stability of the financial systems in the European Union or generate procyclical consequences. The point is not to enable supervisors to provide undertakings with sufficiently long recovery periods so they can avoid negative economical effects as far as possible while re-establishing compliance with the SCR.

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<sup>5</sup> This does not mean that "systemic" undertakings should feel free to take more risks in normal times on the assumption that they are "too big to fail".

- 3.40. In order to enhance harmonisation and to ensure that supervisors use the power vested in them by Article 136(3a) effectively, CEIOPS will also have to look into some sort of coordination process of the extension periods provided across different Member States so that procyclical effects are not only duly considered on the national level but on the European level as well.
- 3.41. The decision on an extension in an individual case should follow a due process. An undertaking has to submit a realistic recovery plan for supervisory approval within two months of the observation of the SCR breach. In order that the recovery plan can take into account any extension to be granted supervisors should provide a short-term supervisory decision about the extension and its length where possible. The undertaking should be given the opportunity to give its views on short notice before any such decision is taken. The supervisor may also ask for additional information it needs to be able to take all relevant factors into account.
- 3.42. If the supervisory authority has already approved a recovery plan following the undertaking's breach of the SCR, the later determination of an exceptional fall in financial markets could – if it affects the undertaking's ability to re-establish compliance with the SCR – lead the supervisor to grant an extension. The extension would require a request by the undertaking concerned<sup>6</sup>, which would have to include an adapted recovery plan. The undertaking would have to submit this within two months from the moment it realises that it will not be able to comply with the original plan.

#### **CEIOPS' advice**

3.43. Factors to be taken into account can be external (independent of the undertaking) as well as internal (entity-specific) and shall include:

##### **External Factors:**

- a) Financial market stability (including systemic risk), in particular the procyclical impact of distressed sales of assets on the financial markets;
- b) Ability of financial markets to provide extra capital at a reasonable price;
- c) Availability in financial markets of adequate financial mitigation instruments (e.g. hedges) at a reasonable price;
- d) Capacity of the reinsurance market to provide reinsurance cover at a reasonable price.

##### **Internal Factors:**

- a) The causes leading to the non-compliance with the SCR;
- b) Degree of non-compliance with the SCR;
- c) The composition of own funds held by the undertaking;
- d) The composition of the undertaking's assets;
- e) Nature and duration of technical provisions and other liabilities;
- f) Solutions effectively available to the undertaking;
- g) Potential availability of support from other group entities (if applicable);

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<sup>6</sup> CEIOPS expects the fact that an exceptional fall in financial markets is taking place to be published. Also supervisors would supply this information to any undertaking that asked for it.

- h) The size or significance of the undertaking relative to the market, i.e. the impact on the market and on policyholders if the undertaking were to experience severe financial problems; and
- i) Steps taken by the undertaking to limit the outflow of capital and the deterioration of its solvency situation.

### 3.4. Regular progress reports

- 3.44. If in the event of an exceptional fall in financial markets the supervisor considers it appropriate to extend the recovery period available to an undertaking, Article 136(3a) of the Level 1 text requires that the undertaking concerned report to the supervisor every three months on its progress towards re-establishment of compliance with the SCR. According to the Level 1 text the report has to include information about the measures taken by the undertaking as well as the progress made towards re-establishing compliance with the SCR.
- 3.45. In case such a report shows that no significant progress has been achieved in reaching the aim of re-establishing compliance, the extension is to be withdrawn.
- 3.46. Since a withdrawal of the extension has serious consequences for the undertaking concerned and the withdrawal according to the Level 1 text is mandatory for the supervisor if no significant progress is shown, it is important for the undertaking as well as for the supervisor to know what constitutes "no significant progress".
- 3.47. The progress achieved refers to the re-establishment of compliance with the SCR. So it is not the remedial actions taken that count, i.e. it does not suffice that the undertaking has (unsuccessfully) worked towards a solution of the deficiency, but rather whether the situation has actually improved according to the objectives of the recovery plan.
- 3.48. Significant progress could be judged against a prescribed benchmark or individually against the undertaking's own recovery plan. CEIOPS favours the latter approach. The undertaking's progress should be assessed taking into account what are reasonable expectations for the specific undertaking in the individual situation. The recovery plan provides a proper basis for this, as the supervisor would not have given its approval unless it considered the plan to be realistic. This approach implies that the recovery plan includes a sufficient number of progress milestones.
- 3.49. In order to make the withdrawal of an extension predictable, supervisors would however still have to establish what degree of fulfilment of the recovery plan is required for the progress to be taken as significant.
- 3.50. When an extension originally granted is withdrawn under such circumstances, the undertaking is still in breach of the SCR but is no longer provided the extended time to remedy the situation according to its own plans as approved by the supervisor, the supervisor will have the power to take appropriate measures against the undertaking concerned. These can be any measures necessary to close the gap between the SCR and the level of own funds as long as they are proportionate, i.e. no other adequate, less onerous measures are available.

- 3.51. The fact that the extension of the recovery period originally provided by the supervisor had to be withdrawn would also be subject to public disclosure according to Article 53(1) of the Level 1 text as it would have to be considered as a major development significantly affecting the relevance of the information disclosed in the Solvency and Financial Condition Report (SFCR). This would be a publication that could be detrimental to the financial situation of the undertaking.
- 3.52. CEIOPS considers that supervisory authorities themselves should also disclose information in connection with the application of Article 136(3a). This publication should cover the number and range of extensions the supervisor has granted and the average duration of the extensions.
- 3.53. CEIOPS' final Advice following its Consultation Papers on Supervisory Reporting and Disclosure and on Transparency and Accountability has been updated to take these expected publications by undertakings and supervisory authorities into account.

## 4. Annex: Impact Assessment

### Description of the policy issues

- 4.1. In its Call for Advice of 1 April 2009, the Commission asked CEIOPS to contribute to the Commission's impact assessment of the Level 2 implementing measures<sup>7</sup>. To this end, a list of issues has been set up by the Commission and CEIOPS, identifying the Level 2 implementing measures that should be accompanied by an impact assessment. The objectives of the issues have been selected among the list of objectives used by the Commission in its Level 1 impact assessment<sup>8</sup>. On 12 June 2009, the Commission has issued an updated list of policy issues and options, to which reference is being made<sup>9</sup>. This impact assessment covers issue 4 of the list of policy issues and options.
- 4.2. Summary tables, published in a separate excel document<sup>10</sup>, accompany the impact assessment.
- 4.3. In considering the requirements arising under Article 136(3a), the operational objectives set out for the extension of the time period in the event of an exceptional fall in financial markets under Solvency II ('Pillar II Dampener') by the European Commission<sup>11</sup> are to (references after the objectives refer to the chapter in the EC Impact Assessment Report):
  - a) Introduce risk-sensitive harmonised solvency standards (objective 3.3.3);
  - b) Harmonise supervisory powers, methods and tools (objective 3.3.5);
  - c) Promote compatibility of prudential supervision of insurance and banking (objective 3.3.7); and
  - d) Promote compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA (objective 3.3.9).
- 4.4. From the list of policy issues and options published by the Commission, CEIOPS has looked to further clarify the detail of these issues and options. The impact assessment for the Pillar II dampener covers one issue, for which a number of options have been considered. These options were considered by CEIOPS as it developed the advice contained within the main sections of this paper.
- 4.5. In the event of exceptional falls in financial markets, provision is made in the Directive to allow supervisory authorities to extend the time period within which insurance and reinsurance undertakings are required to re-establish the level of eligible own funds, covering the Solvency Capital Requirement.
- 4.6. The issue is what should be the maximum period of time which supervisory authorities can give insurance and reinsurance undertakings to re-establish the level of eligible own funds covering the Solvency Capital Requirement in the event of exceptional market falls.

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<sup>7</sup> <http://www.ceiops.eu/media/files/requestsforadvice/EC-april-09-CfA/EC-call-for-advice-Solvency-II-Level-2.pdf>

<sup>8</sup> [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/impactassess/final-report\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf)

<sup>9</sup> <http://www.ceiops.eu/media/files/requestsforadvice/EC-June-09-CfA/Updated-List-of-policy-issues-and-options-for-IA.pdf>.

<sup>10</sup> <https://www.ceiops.eu//media/files/consultations/consultationpapers/CP64/CEIOPS-CP-64-09-Annex-IA-extention-of-the-recovery-period.xls>

<sup>11</sup> See Chapter 3 of the EC Impact Assessment Report at [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/impactassess/final-report\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf).

#### 4.7. The options considered were:

- Option 1. 15 months – i.e. 6+3 (in normal market circumstances) + another 6 months (in the event of exceptional market falls).
- Option 2. 24 months – i.e. 6+3 (in normal market circumstances) + another 6 to 15 months (in the event of exceptional market falls).
- Option 3. 36 months – i.e. 6+3 (in normal market circumstances) + another 15 to 27 months (in the event of exceptional market falls).
- Option 4. 60 months – i.e. 6+3 (in normal market circumstances) + another 27 to 51 months (in the event of exceptional market falls).

#### Cost and benefits

##### - Policyholders and Beneficiaries

- 4.8. For policyholders, the impact of the options will be indirect. In essence, the benefit of having an extended period of time available is that the undertaking can have a longer period to re-establish capital levels at such exceptional times. In the initial stages, policyholders might potentially be adversely affected if a capital deficiency arises (as premiums may rise or benefits decline to improve profitability, for instance, as well as a consequence of the reduction of their overall protection). But without the extended period of time, the undertaking might have to de-risk (selling assets at depressed prices which could lead to further market falls and further disposal requirements, or raising capital at expensive rates) ultimately jeopardising the future of the undertaking, when it might be preferable to delay the disposals or capital raising until the market is more stable or the undertaking has had sufficient time to explore other avenues to restore the level of own funds.
- 4.9. With option 1, the extension period is only an additional six months. While it might be expected that an exceptional fall in financial markets might not last six months, the consequences of that fall may continue for some time, for example in the appetite of the market for capital issues, or depressed asset prices. This option is therefore the most likely to result in an undertaking restoring capital in a way that may ultimately adversely affect policyholders, because it is impossible to be certain whether the impact of the exceptional fall will persist for the whole period. It could result however in an undertaking addressing the compliance quickly, but in a way that is detrimental in the longer term to policyholders and perhaps the industry more widely.
- 4.10. Option 2, where the extension period is up to 15 months, is more likely to lead to a satisfactory resolution of the SCR breach and therefore is likely to have a less negative impact than option 1. But there is still some uncertainty about whether the effects of the exceptional market fall may still persist.
- 4.11. With option 3, where the period of extension is up to 27 months, there is a greater likelihood that the impact of the exceptional falls will be less pronounced within that period and therefore option 3 will have itself a less negative indirect impact on policyholders than either option 1 or 2.
- 4.12. Option 4 would allow a time period of up to 51 months extra. It is envisaged that the impact of the exceptional fall will be much less marked over this time period, and therefore this option is less negative than the other options considered from this point of view. However, undertakings would be allowed to have a level of capital lower than the SCR for 51 months, which also decreases the protection of policyholders.

- Industry/(re)insurance undertakings

- 4.13. The impact on industry of these options is likely to be direct and could take various forms. The more obvious ones are either in raising capital (which may be priced more expensively) or de-risking (at depressed prices), especially if the undertaking is required to address the issue in too short a period of time, without the opportunity to fully explore the alternatives. Indeed, pre-emptive measures might actually exacerbate the market conditions and the undertaking's financial position.
- 4.14. The fact that an exceptional fall in financial markets has been identified means that it is likely that a number of undertakings will fall within this net at that time. The shorter the additional period of time, the greater is the likelihood that the impact might spread even further within the industry, like a domino effect.
- 4.15. Option 1, allowing only a short additional period of time is most likely to lead to the highest cost or impact on undertakings, while option 4, allowing the longest period of time, is likely to lead to the least cost impact. The impact of options 2 and 3 will lie in between these extremities.

- Supervisory authorities

- 4.16. For the supervisory authorities, there are probably two main aspects. The main impact is initially indirect, in that any pre-emptive action taken at a time of exceptional market falls may lead to a continuation or exacerbation of the market conditions, impacting not only the (re)insurance industry. But pre-emptive action, because of the knock-on effects, is more likely to lead to increased supervisory resources to address the issues that brings of more undertakings needing to address non-compliance. Options have a direct impact on the fulfilment of the supervisory objective of maintenance of financial stability.
- 4.17. The risk of these impacts increases the shorter the period of the extension. Thus option 1 is most likely to have the greatest negative impact, with the impact decreasing with options 2 and 3 until it is at its lowest level with option 4. On the other hand, the longer the time period, the greater the risk that the non-compliance of the undertaking continues longer than is necessary once the impact of the exceptional fall has stabilised. With option 4 more resources from supervisory authorities would be needed since undertakings with a level of capital lower than the SCR require a more constant and specific supervision. The objective of maintenance of financial stability would probably be facilitated, but on the other hand the risk for policyholders increases as undertakings remain for a longer period of time with a level of capital below the SCR.

- Comparison and ranking of the policy options based on the efficiency and effectiveness of each option in reaching the relevant operational objectives

- 4.18. As far as the objective of introducing risk-sensitive harmonised solvency standards is concerned, the standards are themselves set at Level 1, so this impact assessment is merely concerned with the maintenance of these standards. Clearly, the most effective way to achieve that is allow the shortest possible period of time to address any deficiency and thus effectiveness would rank from option 1 being the most effective through to option 4 as the least effective. But in terms of efficiency and the market conditions that would prevail at the time these provisions would come into play, option 1 is likely to be the least efficient way to achieve that (as it could have the greatest knock-

on effects to industry or even the economy as a whole), with option 4 being the most efficient.

- 4.19. Turning to harmonising supervisory powers, methods and tools, all the options give similar powers to supervisory authorities. However, these options merely set the maximum period of time, and supervisors are likely to choose a time period considered appropriate for the specific situation of each undertaking. All the options are considered equally efficient, but the shorter the additional period of time, the greater the efficiency in achieving that because there is less likely to be a large divergence in the period adopted for individual circumstances. Thus the options rank from 1 to 4 against this objective.
- 4.20. With the objective of promoting compatibility of prudential supervision of insurance and banking, it is likely that the identification of 'an exceptional fall in financial markets' will be determined in a compatible manner. It is clear if there are equivalent provisions in the CRD to Article 136(3a) in the Level 1 text. On that basis, all of the options will rank equally in terms of effectiveness and efficiency against this operational objective.
- 4.21. In a similar vein, it is not clear how widely the 'exceptional fall in financial markets' will need to be when assessed to tell whether that is compatible with the work of the IAIS and IAA. However, as it reflects the circumstances in the recent crisis, it is likely that equivalent measures may be developed by IAIS and IAA. However, all of the options score equally on effectiveness and efficiency in terms of introducing an extension period that will apply.
- 4.22. In terms of sustainability, it is impossible to tell when these options might be invoked, and what the market circumstances will be at the time. Thus although option 4 would set a time period which is expected to be sufficiently long in most circumstances, it is actually considered by CEIOPS to be too long, and in that sense is less sustainable than either options 2 or 3; option 1 is considered to be too short and therefore might be the least sustainable. When looking at consistency, option 1 is the most likely to lead to consistency because the time period is shorter, while option 4 is the least consistent as the longer period of time would lead to more variation in the time period chosen in individual cases. Options 2 and 3 fall in between these two points.
- 4.23. Clearly, the decision on which option to choose cannot be based on any experience other than the recent crisis and, on that basis CEIOPS considers the time period proposed in option 1 is too tight. As such, it may not lead to a reduction in or mitigate pro-cyclicality, which is actually what it is designed to do. On the other hand, option 4 is considered too long a period of time – it is unlikely that exceptional falls will occur and continue to have an impact throughout the period that would impact on undertakings' ability to address the underlying non-compliance. Indeed it could be implied that the SCR is effectively suspended when there is an exceptional fall in financial markets, and five years is a long time to accept non-compliance of a measure which in normal circumstances has to be met continuously.
- 4.24. CEIOPS therefore considers that both option 2 and option 3 offer a more appropriate extension period, with little to choose between them. As a compromise, on the basis that there is no practical evidence of whether 24 months or 36 months is the more appropriate timeframe to adopt, CEIOPS would suggest that the maximum period be set at up to 30 months, i.e. being 6+3 (in normal circumstances) plus up to another 21 months of extension.