



EIOPA-BoS-18/201  
18 May 2018

## **Opinion on the solvency position of insurance and reinsurance undertakings in light of the withdrawal of the United Kingdom from the European Union**

### **1. Legal basis**

- 1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Opinion on the basis of Article 29(1)(a) of Regulation (EU) No 1094/2010<sup>1</sup>. According to this article, EIOPA shall play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union by providing opinions to competent authorities.
- 1.2. This Opinion is based on Directive 2009/138/EC (Solvency II)<sup>2</sup> and Commission Delegated Regulation (EU) 2015/35 (Delegated Regulation)<sup>3</sup>.
- 1.3. It is addressed to the competent authorities, as defined in point (i) of Article 4(2) of Regulation (EU) No 1094/2010.

### **2. Context and objective**

- 2.1. On 29 March 2017 the United Kingdom (UK) notified the European Council of its intention to withdraw from the European Union. The withdrawal will take place on

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<sup>1</sup> Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

<sup>2</sup> Directive 2009/138/EC of 25 November 2009 of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

<sup>3</sup> Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

the date of entry into force of a withdrawal agreement or, failing that, two years after the notification on 30 March 2019 ('Withdrawal date').

- 2.2. The UK's decision to withdraw from the European Union includes the UK leaving the European single market.<sup>4</sup> The UK will become a third country for the purposes of applying the Solvency II framework after the Withdrawal date. Until then the European Union legislative framework will remain in force in the UK. It is noted that there are ongoing negotiations between the European Union and the UK on a withdrawal agreement. The outcome of these political negotiations is uncertain at this stage and outside EIOPA's remit. Therefore, this Opinion does not consider the consequences of a possible transitional period during which the UK would be part of the European single market and Union law would apply in and to the UK.
- 2.3. In some areas of the determination of technical provisions, own funds and capital requirements, Solvency II differentiates between exposures situated inside and outside of the European Union. Also other provisions that are relevant for the solvency position of insurance and reinsurance undertakings as contained in Directive 2013/36/EU (Capital Requirements Directive),<sup>5</sup> Regulation (EC) No 1060/2009 (CRA Regulation)<sup>6</sup>, Directive 2014/65/EU (MiFID II)<sup>7</sup> and Regulation (EU) No 600/2014 (MiFIR)<sup>8</sup> include distinctions between activities in and outside of the Union. Therefore, technical provisions, own funds and capital requirements of insurance and reinsurance undertakings in Member States other than the UK (EU 27) can change when the UK becomes a third country. The impact of some of these changes can be mitigated, for example when UK exposures or UK credit rating agencies are relocated to EU27 Member States. As these mitigating measures are usually outside of the control of the affected insurance and reinsurance undertakings they are not considered in this Opinion.
- 2.4. Also the technical provisions, own funds and capital requirements of UK insurance and reinsurance undertakings can change with the withdrawal because Solvency II will no longer apply to these undertakings. The future prudential framework for these undertakings is currently unknown. Therefore, the focus of this Opinion is on the solvency position of undertakings in the EU 27 Member States.
- 2.5. The objective of this Opinion is to call upon national supervisory authorities to ensure that the risks for the solvency position of undertakings arising from the UK becoming a third country are properly identified, measured, monitored, managed and reported.

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<sup>4</sup> See: HM Government, The United Kingdom's exit from and new partnership with the European Union, February 2017

<sup>5</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

<sup>6</sup> Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ L 302, 17.11.2009, p. 1).

<sup>7</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

<sup>8</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84).

### **3. Impact of the UK becoming a third country on the solvency position**

- 3.1. As part of their risk management, insurance and reinsurance undertakings are required to identify, measure, monitor, manage and report the risks to which they are or could be exposed.<sup>9</sup> In particular, as part of their own risk and solvency assessment undertakings are required to assess the compliance, on a continuous basis, with the capital requirements and with the requirements regarding technical provisions of Solvency II.<sup>10</sup> In their risk management undertakings should in particular prepare for the scenario that on the Withdrawal date the UK becomes a third country and leaves the internal market.
- 3.2. National supervisory authorities should ensure that the insurance and reinsurance undertakings under their supervision identify, measure, monitor, manage and report the risks arising from the UK becoming a third country and include them in their own risk and solvency assessment. Furthermore, national supervisory authorities should assess the risks arising for their national markets and, where necessary, take mitigating supervisory actions.
- 3.3. The UK becoming a third country and leaving the internal market will cause in particular the following changes to the determination of technical provisions, own funds and capital requirements of insurance and reinsurance undertakings in the EU 27 Member States. Not all of the changes may be relevant for each insurance and reinsurance undertaking.
- (a) The risk-mitigating effect of derivatives can be recognised in the standard formula calculation of the Solvency Capital Requirement (SCR) provided they meet certain qualitative conditions<sup>11</sup>. One of the conditions is that the transfer of risk is legally effective and enforceable in all relevant jurisdictions.<sup>12</sup> After the Withdrawal date UK banks and investment firms will lose the MiFID passport to provide derivative services in the European Union. This could have an impact on the abilities of derivatives provided by UK banks and investment firms to transfer risk after the Withdrawal date. Which derivatives are affected and what the impact is depends in particular on the national legal framework. The SCR of insurance and reinsurance undertakings may already be impacted one year ahead of the Withdrawal date because the risk-mitigating techniques that do not meet the qualitative conditions during the next 12 months can only be recognised partially.<sup>13</sup>
- (b) The calculation of the standard formula SCR for spread risk, market risk concentration and for counterparty default risk is based on ratings of the assets of the insurance and reinsurance undertakings. Moreover, the

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<sup>9</sup> Article 44(1) of Solvency II

<sup>10</sup> Article 45(1)(b) of Solvency II

<sup>11</sup> Articles 209, 210, 212, 213 of the Delegated Regulation

<sup>12</sup> Article 209(1)(a) of the Delegated Regulation

<sup>13</sup> Article 209(2) of the Delegated Regulation

recognition of risk-mitigation techniques in the SCR calculation can depend on the rating of the counterparty. Undertakings may use an external credit rating only where it has been issued by an external credit assessment institution (ECAI) or has been endorsed in accordance with the CRA Regulation. The UK credit rating agencies will be deregistered after the Withdrawal date and will no longer qualify as ECAIs. Assets of the insurance and reinsurance undertakings may therefore lose their ECAI ratings.<sup>14</sup> Accordingly, the ratings of a deregistered ECAI can still be used for regulatory purposes during a period of 10 days if the instruments are also rated by at least one other registered credit rating agency, or three months if the instruments are not rated by any other registered credit rating agency. The European Securities and Markets Authority (ESMA) may extend, including following a request by the European Banking Authority (EBA) or EIOPA, the three month period by three months in exceptional circumstances relating to the potential for market disruption or financial instability.

- (c) Insurance and reinsurance undertakings are required, where necessary, to take measures to ensure service continuity regarding the insurance contracts concluded in the UK by way of freedom of establishment and freedom to provide services.<sup>15</sup> Where measures are not taken or the measures taken turn out to be ineffective, undertakings may not be authorised anymore to service these contracts after the Withdrawal date although those contracts remain in principle valid after that date. As a consequence, the technical provisions for these contracts may need to be changed in particular because the expected profit from these contracts cannot be earned anymore or only with delay.
- (d) Depending on the national legal framework for reinsurance activities, UK insurance and reinsurance undertakings may not be able anymore to provide reinsurance services in some EU 27 Member States after the Withdrawal date unless they take measures to secure market access. Where insurance and reinsurance undertakings currently account for reinsurance recoverables from a UK insurance or reinsurance undertaking and that UK undertaking would not be authorised anymore for reinsurance activities in their jurisdiction after the Withdrawal date, they may need to reduce the amount of recoverables because the payments expected from the UK undertaking may not be made anymore or only with delay.
- (e) The calculation of the matching adjustment and of the volatility adjustment to the risk-free interest rate depends on the fundamental spreads of assets. The fundamental spread for government bonds of Member States differs from that of government bonds of other countries. For Member States, the fundamental spread is 30% of a long-term average spread of the government bonds, while for other countries it is 35% of that long-term average spread.<sup>16</sup>

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<sup>14</sup> Article 24(4) of the CRA Regulation

<sup>15</sup> See EIOPA's Opinion on service continuity in insurance in light of the withdrawal of the United Kingdom from the European Union of 21 December 2017.

<sup>16</sup> Article 77c(2)(b) and (c) of Solvency II

The long-term average spread for UK government bonds is currently zero. In case that long-term average spread becomes positive the fundamental spread will increase after the Withdrawal date and may decrease the matching adjustment and the volatility adjustment in particular for the pound sterling.

- (f) The calculation of the matching adjustment to the risk-free interest rates is based on the ratings of the assets in the matching adjustment portfolio of the insurance or reinsurance undertaking.<sup>17</sup> Undertakings may use an external credit rating only where it has been issued by an external credit assessment institution (ECAI) or has been endorsed in accordance with the CRA Regulation. The UK credit rating agencies will be deregistered after the Withdrawal date and will then no longer qualify as ECAIs. Assets included in matching adjustment portfolios may therefore lose their ECAI ratings. The CRA Regulation includes a transitional provision for the case of withdrawal of registration. The CRA Regulation includes a transitional provision for the case of withdrawal of registration, as explained in point (b) above.
- (g) A specific type of Tier 2 ancillary own funds item is a letter of credit or a guarantee provided by a credit institution authorised in accordance with the Capital Requirements Directive.<sup>18</sup> Letters of credit and guarantees provided by a UK credit institution would no longer fall under that specific type of item and may, depending on their characteristics, fall out of Tier 2 or may not be recognised at all after the Withdrawal date.
- (h) Solvency II requires that participations in financial and credit institutions as defined in the Capital Requirements Directive are deducted from eligible own funds in certain cases.<sup>19</sup> UK financial and credit institutions will cease to fall under the Capital Requirements Directive after the Withdrawal date. However, as clarified in EIOPA's guidelines on the treatment of related undertakings including participations,<sup>20</sup> the specific treatment for participations in financial and credit institutions applies not only to financial and credit institutions within the scope of EU Directives, but to all financial and credit institutions.
- (i) The SCR standard formula risk charge for spread risk and market risk concentration of Member States' government bonds is zero.<sup>21</sup> This approach applies to exposures to the central government and the central bank denominated and funded in the domestic currency of that central government and the central bank and to exposures to specific regional governments and local authorities that are treated in the same way as their central government. Exposures to the UK central government, its central bank and to three UK regional governments<sup>22</sup> currently fall under that approach but will cease to do

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<sup>17</sup> Article 77c of Solvency II

<sup>18</sup> Article 74(e) of the Delegated Regulation

<sup>19</sup> Article 92 of Solvency II and Article 68 of the Delegated Regulation

<sup>20</sup> Guideline 2, see [https://eiopa.europa.eu/Publications/Guidelines/TRU\\_Final\\_document\\_EN.pdf](https://eiopa.europa.eu/Publications/Guidelines/TRU_Final_document_EN.pdf).

<sup>21</sup> Articles 180(2) and 187(3) of the Delegated Regulation

<sup>22</sup> Article 1(15) of Commission Implementing Regulation (EU) 2015/2011

so after the Withdrawal date. Depending on the credit quality step of UK government bonds, the SCR for these exposures may increase.

- (j) The standard formula SCR for market risk concentrations and counterparty default risk usually depends on the rating of the exposure. Unrated exposures are treated like exposures with the worst credit quality step 6. However, for exposures to unrated insurance and reinsurance undertakings the SCR is derived from the solvency ratio of the undertaking, resulting in lower capital requirements if the ratio is above 100%.<sup>23</sup> After the Withdrawal date, exposures to unrated UK insurance and reinsurance undertakings would become third country insurance and reinsurance undertakings and would therefore not fall under that provision anymore. Similarly, lower capital requirements apply with regard to exposures to unrated financial and credit institutions that are subject to the Capital Requirements Directive and comply with the banking capital requirements.<sup>24</sup> After the Withdrawal date exposures to unrated UK financial and credit institutions would not fall under that provision anymore.
- (k) The risk-mitigating effect of reinsurance can be recognised in the SCR standard formula calculation provided it meets certain qualitative conditions<sup>25</sup>. In particular, the reinsurance cover needs to be provided by:
- i. an insurance or reinsurance undertaking that complies with the SCR,
  - ii. a third country undertaking that is subject to an equivalent solvency regime and complies with the solvency capital requirements of that regime, or;
  - iii. a third-country undertaking that is subject to a solvency regime not deemed equivalent and has a rating corresponding to credit quality step 3 or better.<sup>26</sup>

Reinsurance cover provided by UK insurance and reinsurance undertakings currently falls under point (i). After the Withdrawal date, it would not fall under point (i) anymore and in the absence of a positive equivalence decision also not under point (ii). In that case the reinsurance cover falls under point (iii) and can only be recognised if the undertaking has a rating of credit quality step 3 or better.

- (l) Under Solvency II amounts recoverable from special purpose vehicles (SPVs)<sup>27</sup> are usually treated like reinsurance recoverables. The legal framework includes criteria and provisions relating to the mandatory authorisation of such SPVs in the Member State where it is or will be

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<sup>23</sup> Articles 186(2), 193(1)(f), 199(3) of the Delegated Regulation

<sup>24</sup> Articles 180(8) and 186(5) of the Delegated Regulation

<sup>25</sup> Articles 208 to 211, 213 of the Delegated Regulation

<sup>26</sup> Article 211(2) of the Delegated Regulation

<sup>27</sup> SPVs as defined by Article 13(26) and subject to Article 211 of Solvency II

established.<sup>28</sup> Risk transfers to SPVs are considered risk-mitigation techniques in the SCR standard formula calculations only if certain conditions are met.<sup>29</sup> Furthermore, where risk is transferred to an SPV that is regulated by a third country supervisory authority, the risk-mitigation technique can only be taken into account in the basic SCR where requirements equivalent to those set out in Article 211(2) of Solvency II are met by the SPV.<sup>30</sup> Therefore, the recognition of risk transfer of UK SPVs may change after the Withdrawal date depending on the requirements in UK national law applicable then.

- (m) The scope of group supervision under Solvency II depends in particular on whether the parent undertaking of the insurance group is located in the EU.<sup>31</sup> For insurance groups with a UK parent undertaking and subsidiaries across other Member States the scope of group supervision will therefore change after the Withdrawal date.<sup>32</sup>
- (n) Group internal models can be used to calculate both the SCR at group level and the SCR at the level of insurance and reinsurance undertakings in the group.<sup>33</sup> Where an insurance group with a UK parent undertaking applies such an internal model, it cannot be used anymore to calculate the SCRs of the insurance and reinsurance undertakings in the group that are located in the EU27 Member States without re-approval by the national supervisory authority. In the absence of any other approved internal model, the SCR for these undertakings would have to be calculated on the basis of the standard formula.

#### **4. Monitoring by EIOPA**

4.1. In conjunction with national supervisory authorities, EIOPA will monitor the risks for the solvency position of insurance and reinsurance undertakings arising from the UK becoming a third country on an ongoing basis. The monitoring will be proportionate to the nature, scale and complexity of the risks. National supervisory authorities should provide to EIOPA the necessary information for this monitoring within the current European Union framework for supervisory co-operation.

4.2. This Opinion will be published on EIOPA's website.

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<sup>28</sup> Article 211(2) of Solvency II, Articles 318 to 327 of the Delegated Regulation

<sup>29</sup> Article 211 of the Delegated Regulation

<sup>30</sup> Article 211(6) of the Delegated Regulation

<sup>31</sup> Articles 213 to 217 of Solvency II

<sup>32</sup> Articles 260 and 261 of Solvency II

<sup>33</sup> Article 231 of Solvency II

Done at Frankfurt am Main, 18 May 2018

[signed]

Gabriel Bernardino

Chairperson

For the Board of Supervisors