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Solvency II newsflash

EIOPA's information request on the 2020 review of Solvency II

Executive Summary

Following its mammoth 800-page October consultation paper (the "Consultation Paper"), on Monday 2 March 2020, the European Insurance and Occupational Pensions Authority ("EIOPA") released an information request for National Supervisory Authorities ('NSA'). This information request is intended to feed into EIOPA's final opinion to the European Commission on the 2020 review of Solvency II, which is due in June 2020.

Although EIOPA declares in the technical specification that its "position as reflected in this information request is not final", the request does perhaps hint at EIOPA's current thinking. Three important areas that EIOPA is testing are:

- **Risk Margin** – EIOPA has asked firms to report the impact of applying a "tapering approach" that was first suggested by the Association of British Insurers. This approach will reduce the size of the risk margin, possibly materially so, for firms with long-term liabilities.
- **Risk-free rates** – Firms are to demonstrate the impact of using an alternative risk-free rate term structure, which has been calculated using an alternative extrapolation method. This may reduce the value of very long-term sterling-denominated liabilities
- **Volatility adjustment** – EIOPA's request asks firms to use an alternative calculation approach for the VA which takes into account features of firms' ALM strategy. This may increase the VA from 15bps up to a maximum of 33bps for some firms.

In this newsflash, we look at these elements in more detail, along with a selection of the other proposals that EIOPA's is seeking to test, providing comments on some of the potential impacts on firms. We have focussed on life insurers and have not considered the impact on non-life firms.

If you'd like to discuss any element of the information request in more detail, please get in touch.

Overview of the request

NSAs must chose a sample of firms to cover at least 50% of insurance business within each country (measured by Technical Provisions for life business). The timescales are very tight – EIOPA has requested that insurers submit the information to the relevant national supervisory authority ("NSA") by 31 March 2020. The NSA will then submit final, validated information to EIOPA on 16 April 2020.

EIOPA has requested that firms provide the requested information calculated as at 31 December 2019 in line with three scenarios:

- **Baseline** – according to the current Solvency II framework
- **Scenario 1** – with changes in line with EIOPA's "tentative advice" as outlined in the technical specification that accompanies the information request
- **Scenario 2** – as in Scenario 1, but with the current treatment of interest rate risk in the Standard Formula.

So, what is EIOPA's tentative advice?

EIOPA's tentative advice

EIOPA's tentative advice addresses a number of key areas of the Solvency II regulation, including some of the long-term guarantees measures (for example, the Matching Adjustment ("MA") and the Volatility Adjustment ("VA")), the much-debated risk margin, and the risk-free curve itself.

Risk Margin

For the Risk Margin, EIOPA has requested that firms adopt a modified calculation as follows:

$$RM = CoC \cdot \sum_{t \geq 0} \frac{SCR_t \cdot \max(\lambda^t; 0.5)}{(1 + r_{t+1})^{t+1}}$$

Where $\lambda = 0.975$ and CoC remains a 6% constant.

EIOPA's proposed approach is identical to the "tapering approach", which is set out in this September 2019 Institute and Faculty of Actuaries Risk Margin Working Party paper. This is itself a summary of a submission made to EIOPA by the Association of British Insurers in 2018.

The tapering approach is intended to address dependency over time within the SCR calculation – for instance, some non-hedgeable risks may be non-repeatable (the example given is that curing cancer will only happen once). If firms were to allow for this, there would be a downwards impact on the projected SCRs within the risk margin calculation.

Using a value of λ that is less than one in the calculation outlined above captures this effect. The ABI's submission considered several values for λ: "(1) capital funded under the current Risk Margin (λ = 1); (2) capital required to fund a perpetual bond (λ = 0.97); (3) capital required to fund a standard formula shock every year (λ = 0.92); and (4) capital required to fund a reasonable lifetime shock (λ = 0.84)".

EIOPA's current proposal (λ = 0.975) lands in between the ABI's value (1) and value (2) above.

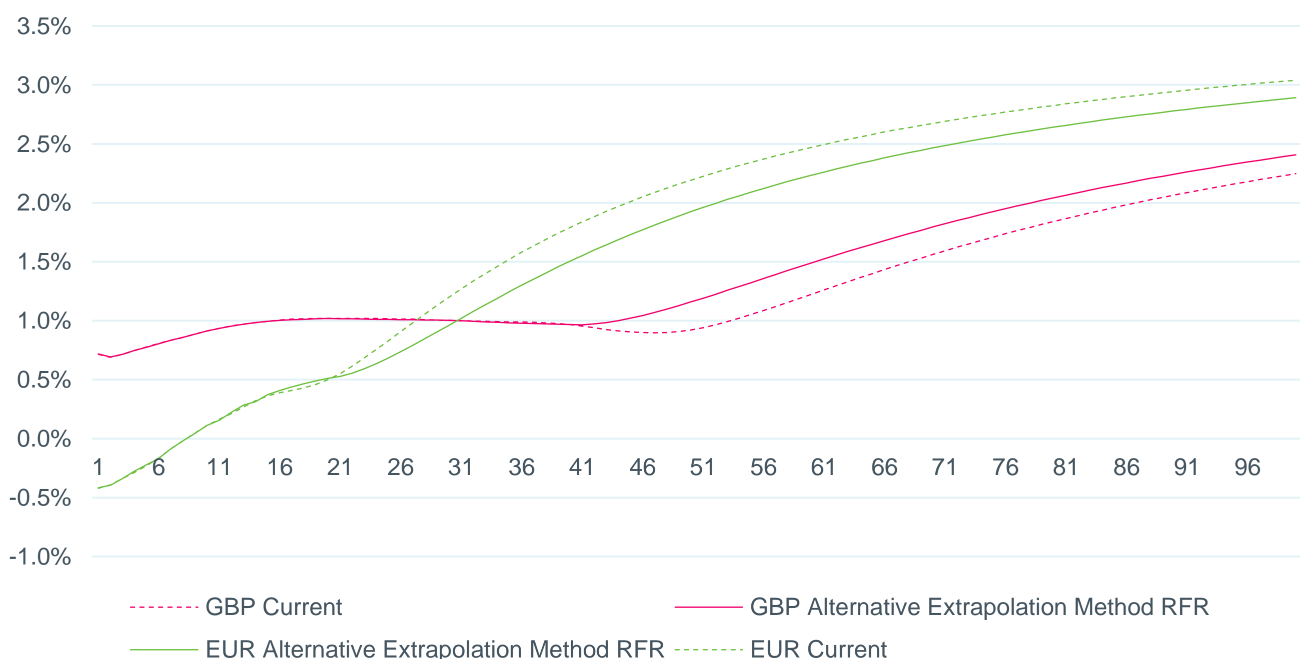
Although this change is likely to be welcome, some insurers may want EIOPA to go further still. And, for UK-based insurers, there's the question of Brexit – will the PRA follow this change, or will it simply go its own way on the risk margin?

Risk-free term structure

EIOPA has proposed an alternative extrapolation method for the risk-free term structure (in line with "Option 5" within the October Consultation Paper, paragraph 2.90).

Under the existing approach, information after the last liquid point (the "LLP") is disregarded and the risk-free term structure is smoothed towards the ultimate forward rate (the "UFR"). The alternative extrapolation method uses a "First Smoothing Point" or "FSP". After the FSP, the extrapolation approach takes into account market information, but begins to smooth towards the UFR.

The chart below demonstrates the impact of applying the alternative extrapolation method on the Euro and Sterling risk free term structures. Below, the proposed "First Smoothing Point" for Sterling is 40 years, which differs to the current LLP of 50 years.



Source: Monthly Technical Information December 2019 and Technical Information accompanying EIOPA's data request

The chart shows opposite impacts of the change in extrapolation method for the Sterling and Euro risk-free term structures; the Sterling term structure increases whereas the Euro term structure falls.

The higher risk-free term structure for Sterling, with a consequent reduction in the value of long-term liabilities, may surprise some. However, this result was replicated in Annex 2.6 of EIOPA's Consultation Paper (see page 791), and appears to be a result of the FSP in the proposed approach falling 10 years before the LLP under the current approach. We see a similar result for some other currencies, including the US Dollar and the Swiss Franc.

It is not clear how important this result will be for UK firms – particularly because it only impacts the Sterling risk-free term structure for tenors over 40 years, However, when combined with other changes, such as that proposed for the risk margin, it may be significant for certain classes of business, including deferred annuities.

The fall in the term structure for the Euro risk-free term structure may cause some pain for insurers with Euro-denominated liabilities. However, this may be a signal that EIOPA is not going to propose pushing out the Euro LLP to 30 or 50 years – a move that was considered in the October Consultation Paper and that would have particularly impacted insurers in Germany and the Netherlands, where many have written costly long-term guarantees.

Volatility Adjustment

EIOPA's request for information combines several proposals for the VA from the October Consultation Paper.

Under the tentative advice outlined in EIOPA's request, firms would calculate the VA as the sum of the so-called "permanent VA" and the "macroeconomic VA".

Permanent VA

EIOPA has asked firms to calculate the permanent VA (which is intended to be firm-specific), by taking 85% of the risk-corrected spread on the reference portfolio, and adjusting this by two "application ratios":

1. "Application ratio 4", which allows for an insurer's mismatches in its fixed income assets and insurance liabilities in respect of duration and volume (as set out in paragraph 3.61 of the consultation paper); and
2. "Application ratio 5", which accounts for the illiquidity characteristics of liabilities in the valuation of technical provisions" (as set out in paragraph 2.396 of the Consultation Paper).

The maximum possible value of either application ratio is 100%. This would correspond to an insurer investing in illiquid assets with cash flows that are well-matched in timing and amount to the liability cash flows. In this case, the insurer would calculate its VA as 85% of the risk-corrected spread on the reference portfolio (currently, firms may only take credit for 65% of the risk-corrected spread in the VA).

Using data provided by EIOPA within the "Technical Information" accompanying the request, and applying the draft approach outlined, the maximum possible VA (for Sterling-denominated liabilities) that a firm could report as at 31 December 2019 is 33bps[1]. The equivalent VA using the existing methodology is 15 bps.

Therefore, the formulation of the VA being tested is likely to result in an increase in the VA for some insurers. However, although the tested approach will capture features of an insurer's ALM strategy, it does not go as far as the "undertaking-specific VA"[2], which would involve calculating a VA on the firm's own assets, rather than using a currency-specific portfolio.

Macroeconomic VA (i.e. country-specific VA)

In the technical specification, EIOPA suggests that it would have additionally asked firms to include allowance for the "macro-economic VA" (or a country-specific VA). And for this purpose, EIOPA appears to prefer the "Amend the trigger and the calculation of country-specific increase of the VA" option (as it is called in the Consultation Paper). However, as at 31 December 2019, EIOPA states that the "macroeconomic VA would not have been triggered for any country" and so it does not require any submission from firms in respect of this.

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[1] We calculate 33bps using the formula provided by EIOPA in paragraph 58 of its Information Request ($VA = GAR \cdot AR4 \cdot AR5 \cdot Scalec \cdot RC_S$) and information provided in the technical information accompanying the request. The calculation is simply: 85% x 100% x 100% x 182% x 0.212% = 0.328%.

[2] EIOPA summarises each of the VA options that are under consideration within paragraph 2.302 of the October Consultation Paper. It describes the undertaking-specific VA as: "calculating the VA based on the undertaking-specific asset weights. For each asset class, the spreads used in the calculation of the VA would still be the same for all undertakings and taken from market indices." For reference, the other options that EIOPA includes in its information request are Options 4, 5 and 7.

Other areas considered in EIOPA's request

Below we summarise some of the remaining areas in which EIOPA requires firms to change the existing Solvency II methodology for the purpose of the information request.

<table>
<tr><th>Area</th><th>Tentative advice</th></tr>
<tr><td>Matching adjustment (“MA”)</td><td>EIOPA requires firms to provide information with two adjustments relating to the MA:
1. “Ignoring the adjustment prescribed in Art. 81” of EC 2015/35 (the “Delegated Acts”), which currently disallows firms from recognising surplus arising in ring-fenced MA portfolios.
2. “SCR calculated applying full diversification benefits regarding the matching adjustment portfolios and the rest of portfolios.”
These changes will impact insurers in the UK and Spain only – the only countries with firms that apply the MA. EIOPA's Report on the Long-term Guarantees Measures and Measures on Equity Risk states that as at 31 December 2019, 19 insurers in the UK and 15 in Spain apply the MA.
In the UK, this may have limited impact – most MA portfolios are run by internal model firms, which, subject to PRA approval, can already take credit for diversification benefit.</td></tr>
<tr><td>Best estimate liability – contract boundaries</td><td>In providing their responses, EIOPA has asked firms to amend the application of the contract boundary rule (as set out in paragraph 18(3) of the Delegated Acts).
Paragraph 18(3) requires an insurer to recognise cash flows only up to the point where it can adjust premiums to fully reflect risks.
An exception to this currently applies where the insurer conducted an individual risk assessment at inception and “that assessment cannot be repeated before amending the premiums or benefits”.
EIOPA has adjusted this to state the exception is where firms “do not have the right to” rather than “cannot”.</td></tr>
<tr><td>Best estimate liability – expenses</td><td>EIOPA has asked firms to adjust their allowance for expenses. In this case, to amend the interpretation of Article 31(4) of the Delegated Acts, which currently states that “Expenses shall be projected on the assumption that the undertaking will write new business in the future”.
For the purpose of the information request, firms are asked to change their reading of this to take into account “the decisions of the administrative, management or supervisory body of the undertaking with respect to writing new business”.</td></tr>
<tr><td>Standard formula – interest rate SCR</td><td>Yet again EIOPA has dusted off its interest rate risk stress proposals for Standard Formula firms. These are a repeat of the proposals in EIOPA's second set of advice on Solvency II's Standard Formula. At that time, the proposed changes, which were an “own-initiative”, were rejected by the European Commission.
The core intention of the proposals is for the “down stress” to the risk-free term structure to include consideration of negative rates. These changes will predominantly impact German and Dutch insurers given the prevalence of onerous long-term guarantees in these insurance markets.</td></tr>
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Standard Formula – Long-term equity ("LTE") SCR	The LTE amendments to the Delegated Acts were made by the European Commission to permit firms to apply a reduced risk charge of 22% when certain requirements are met. In its Consultation Paper, EIOPA made no secret of the fact it is not a fan of the LTE amendments, stating that "it is not possible to corroborate the assertion that investment for a longer duration justifies a lower capital charge". EIOPA went on to state that "the data actually supports an increase in capital requirements". EIOPA's proposals in the Consolation Paper in relation to LTE addressed concerns regarding overlap with other equity risk SCR modules (in particular, the duration-based equity module) and the potential to "game" the calculation (if firms consider an intra-group holding a long-term holding). The information request largely reflects EIOPA's concerns in these areas – in particular, EIOPA has requested that firms respond to the information request complying with a new set of eligibility criteria for the LTE module. For instance, firms must ensure that the equity investments are "properly diversified" and "Controlled intra-group equity investments shall be excluded".

Next Steps

Firms have until the end of March to complete their submission for the relevant NSA. If you would like to discuss any aspect of EIOPA's request for information with one of our specialists, please get in touch.

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