HYMANS ROBERTSON

Solvency II newsflash

EIOPA publishes recommendations following its 2020 review of Solvency II

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On Thursday 17 December EIOPA published an early Christmas present in the form of its recommendations following the 2020 review of Solvency II. In this short Newsflash we discuss some of the key recommendations and what they could mean for insurers. The EIOPA opinion plus analysis and impact assessment can be found in full here.

At a glance

Below we summarise the key changes from our perspective.

Risk Margin (see page 2 more detail)

- A "tapering" approach is to be introduced, which is expected to both reduce the size of the Risk Margin and its sensitivity to interest rates. The estimated impact is a 15% reduction in Life Risk Margins across Europe.
- The approach involves modifying the cost of capital approach so that each projected SCR is multiplied by a reduction factor – with SCRs at later times being reduced by a greater amount.

Extrapolation of the risk-free rate

- The "alternative extrapolation method" has been proposed, which will impact all currencies – whereas we were expecting this change to only impact the Euro risk-free rate.
- EIOPA proposes a change to the extrapolation of the risk-free rate beyond the last liquid point (which is to be renamed the first smoothing point). This change will result in the risk-free rate converging to the ultimate forward rate slightly more slowly and therefore is expected to increase liabilities in most Eurozone countries.
- In addition, EIOPA proposed that the first smoothing point for GBP would be 30 years, whereas the current last liquid point is 50 years. This would be expected to increase the risk-free rate for GBP-denominated liabilities with durations of over 30 years.

Equity risk symmetric adjustment

- The symmetric adjustment which applies to the equity risk charge within the Standard Formula has been revised such that it is now limited to be between +/- 17% (currently +/- 10%).
- In its current form, the reduction has proven valuable to Standard Formula insurers with high levels of equity risk, so this could increase that benefit in one direction. Clearly it could also inflict higher charges.

Standard Formula interest rate risk

- As has been expected for some time, the stresses applied to the risk-free rate curve are proposed to be changed to allow for negative rates of up to -1.25% in the down stress. The change is expected to lead to an average SCR increase of 12% across Europe and will be phased in over 5 years.
- The correlation parameter between interest rates down stress and spread risk is proposed to be reduced to 0.25.

Volatility adjustment

- The VA calculation has become more complicated. It is now the sum of a "permanent" VA and a "macroeconomic" VA which is designed to prevent pro-cyclicality. The revised calculation will now incorporate the degree of matching and the illiquidity of the insurer's liabilities and deals with the cliff effect within the country component which was an issue for Eurozone insurers.
- Standard Formula firms will still not be allowed to use a dynamic VA. For internal model firms, the DVA has to be calculated allowing for the most onerous SCR assuming the insurer's asset portfolio and assuming the VA reference portfolio.

Diversification between MA and non-MA portfolios

- Although already adopted within most internal models, it is proposed that the limits on diversification between MA and other portfolios will be removed when calculating the SCR.

Standardised sensitivity testing

- Standard sensitivities are to be introduced, as well as an invitation to disclose additional ones that suit the risk profile. This isn't likely to change a lot of what is currently disclosed in the UK.

A focus on the Risk Margin

It is perhaps something of a surprise that EIOPA has proposed making concessions on the Risk Margin, since it has appeared unwilling to concede to industry concerns for the past five years.

UK annuity writers, in particular, argued they are already required to hold capital to guard against a severe longevity stress. If this stress event did occur – the classic example being the discovery of a cure for cancer – then it seems reasonable to assume that the insurer's subsequent exposure to longevity risk would be lower: cancer can, after all, be cured only once. The industry has previously argued that this should be reflected in the projection of the SCR for longevity risk that is used to calculate the Risk Margin, and EIOPA now seems to have accepted these arguments.

EIOPA's proposal is to adjust the cost of capital formula used to calculate the Risk Margin so that insurers will project the SCR that they expect to hold against non-hedgeable risks in each future year, and will then multiply each projected SCR by a reduction factor – with greater reductions applied to capital held further in the future. The updated formula would be:

$$RM = CoC\ (6\%) * \sum_{t \geq 0} \frac{\max(\lambda^t, floor) * SCR_t}{(1 + r_{t+1})^{t+1}}$$

EIOPA proposes that λ would be 97.5% (this is the least beneficial of the options originally proposed), and that the floor would be 50%.

An Institute and Faculty of Actuaries working party previously examined the impact that the tapering approach might have on the Risk Margin arising from a simple portfolio of annuities in payment. Based on a number of simplifying assumptions, the working party estimated that approach might reduce the Risk Margin by around 20% (although this

did not take account of the floor of 50% proposed by EIOPA). In addition to reducing the size of the Risk Margin, the working party's analysis suggested that the tapering approach could marginally reduce the sensitivity to interest rates.

What happens next?

At this stage, all recommendations must be reviewed by the European Commission before any amendments to the Delegated Acts are proposed, and any such amendments would themselves require approval from the European Parliament. This process would likely take a number of years and EIOPA Chair Gabriel Bernardino has suggested that any recommended changes will not come into force before 2024.

With the UK having already technically left the EU and the expectation that a new solvency regime for the UK will be in place before any proposed changes are approved, changes are unlikely to directly affect UK insurers. However, they will apply to those with EU subsidiaries.

As we discussed in a previous Newsflash, the future regulatory framework in the UK is also currently being reviewed. While It seems likely that the UK will tailor many aspects of the current framework to be more appropriate for the characteristics of the UK market, should it wish to gain Solvency II equivalence, the new framework will have to remain broadly aligned with Solvency II and so the EIOPA recommendations will remain of interest to UK insurers. This may include adopting any changes to the Standard Formula approved by the European Parliament.

In particular, the PRA has long been in favour of changing the approach to calculating the Risk Margin, and EIOPA's apparent willingness to consider changes might embolden the PRA to proceed with its own plans for tackling the issue. However, it is not clear whether the PRA would be in favour of adopting a similar "tapering" approach, or whether it would resurrect its previous plans to link the size of the Risk Margin to the cost of reinsurance.

We continue to speak to a wide range of insurers across the UK and abroad about Solvency II developments and how this could impact their business. If you would like to discuss these points further, please get in touch with one of the authors of this Newsflash.