EIOPA - IRSG

Initial comments on EIOPA discussion paper issues relating to the Solvency II Solvency Capital Requirement standard formula

Background

- European Commission issued call for advice to EIOPA on a review of specific items of Solvency II Delegated Regulation, and in particular of the Solvency Capital Requirement ("SCR") standard formula (July 2016).
- EIOPA issued a discussion paper seeking to engage in a dialogue with stakeholders to help it in narrowing down its policy approach (November 2016).
- The discussion paper contains questions relating to 21 specific aspects of the standard formula.
- We have pulled together draft responses from members of a subgroup representing the IRSG and seek input from all IRSG members in advance of the submission deadline of 3 March.

Subgroup considering issues

- Olav Jones (joint leader)
- Tony O'Riordan (joint leader)
- Petra Chmelova
- Mirenchu del Valle
- Hugh Francis
- Thomas Keller
- Roger Laeven
- Annette Olesen
- Ioannis Papanikolaou
- Karel van Hulle

Plan for completion of task

Date	Action
10 February	Subgroup leaders circulate first draft of comments to EIOPA for onward transmission to IRSG as input to IRSG meeting
15 February	IRSG meeting, all members to discuss emerging key positions. Available subgroup members meet to discuss response
20 February	Subgroup leaders to send second draft response to subgroup members
22 February	Subgroup members to provide feedback
24 February	Subgroup leaders to send final draft to all IRSG
1 March	All IRSG members to approve or provide blocking issues with suggested edit
3 March	Submit response to EIOPA

Emerging key points in draft responses

1. Simplified calculations

- Supportive of allowing simplified calculations
- Propose that simplifications be allowed on a wider basis, not solely following prescribed approaches.
- Non-prescribed simplifications should be required to be immaterial to the SCR and documented, but steps should be taken to avoid supervisors requiring excessive documentation.

2. Reducing reliance to external credit ratings

- Ability to use ECAIs should not be reduced or addition burdens placed on those those using them, however reliance on ECAIs should be reduced by expanding the range of alternatives
- Viable alternatives should be allowed, such as:
  - internal credit assessment
  - third party assessment
- There are pros and cons to extending options (less reliance on ECAIs, allows for entities without ECAI ratings, could improve risk management BUT needs consistent rules)
- Credit quality steps should be maintained

Key points in draft responses

3. Treatment of guarantees, 3rd party and RGLA exposures

- Scope of third party guarantees should be expanded. They should include guarantees of the following types:
  - Direct guarantees by RGLA – companies exposed to RGLAs directly
  - Guarantee provided by third party, which itself is a counter-guarantee by an RGLA
  - Guarantees provided by agencies or branches, operated by an RGLA (eg in Belgium – VIPA and VMSW).
- The risk-mitigating effect of partial guarantees should be recognized in S2.
- Type 2 exposures should be included in the RGLA guarantee treatment – there are Type 2 exposures which are guaranteed by central government, eg the National Mortgage Guarantee in the Netherlands.

5. Volume measure for premium risk

- Approach for measurement of premium risk needs improvement but EIOPA proposal would lead to excess measurement of premium
- For example, the following should be considered: Taking Maximum of
  - A) all 2016 premiums including future premiums from contracts from 2016
  - B) all 2017 expected premiums incl. expected future premiums from contracts in 2017
- We agree the current exclusion of any pricing (i.e. profit) from the premium risk measure makes the measure less risk sensitive and can have perverse effect of increasing capital when a company increases pricing to reduce premium risk. Use of combined ratio should be considered to address this.

Key points in draft responses

6. Parameters for non-life premium and reserve risks and medical expense risk

- Risk sensitivity could be improved by taking national differences in product design into account.
- Recalibration should take place even if the number of undertakings providing data is not greater than in the previous exercise.

7. Natural catastrophe risks

- Where factors for different regions are very similar, they should be harmonised to avoid spurious accuracy. Regions based on political borders should be replaced by zones derived from event characteristics.
- Exposure values should be more clearly defined.
- Historical evidence to support approaches is insufficient.

Key points in draft responses

8. Man-made catastrophe risk

- Required data is often not available, e.g. insured buildings within 200m radius. Calculations should be simpler, reflecting availability of data.

9. Health catastrophe risk

- The scenario in 9.2 seems conservative enough to properly reflect a terror risk scenario.
- Accident concentration risk could be simplified, for instance by considering group accident contracts or allowing approximations concerning buildings with highest concentrations.
- Pandemic risk sub-module requires estimates relating to a number of factors which can not readily be estimated.

Key points in draft responses

10. Calibration of mortality and longevity risk

- The Lee Carter model is established, understood and strikes a good balance between accuracy and simplicity.
- A number of methods could be used to deal with parameter uncertainty.
- Expert judgement is subjective and should be avoided in estimating future deviations.
- A more granular approach for longevity and mortality risks is appropriate.

11. USP/GSP on underwriting risks

- Areas for which USPs are allowed should be expanded, potentially to include:
  - Life, non-life and health lapse (and mass lapse) risk
  - longevity and mortality risk
  - correlations between risks
- Data requirements should be simplified and criteria should be set out to establish the suitability of proposed methods. For instance, insurers are unlikely to be able to calibrate a mortality or longevity trend model on their own portfolios. Excessive documentation requirements should be avoided.

Key points in draft responses

12. Simplifying the counterparty default risk module

- No simplifications are suggested
- The determination and derivation of probability of default should be explained.

13. Exposures to qualifying central counterparties and derivatives

- Capital charges for counterparty default risk on derivatives ignore the EMIR requirements which materially reduce counterparty risk. As a result, risk exposures are double counted and capital requirements overstated.

14. Market concentration risk

- We see no ambiguities regarding the scope of this sub-module.

Key points in draft responses

15. Currency risk at group level

- We consider FX translation risk to be a real risk.
- Own funds should be considered as fungible across a group.
- Currency risk methodology at group level needs changing because it inappropriately penalises holding assets backing local solvency requirements in local currency. This incentivises an inappropriate currency mismatch.

16. Look-through approach

- We agree that a definition of an "investment related undertaking" is needed, for which look through can always be applied. A key criterion should be that the vehicle has no purpose other than the holding of assets. We generally agree that the elements identified by EIOPA are relevant.
- The look-through approach should be optional for investment related undertakings as it may be costly, though potentially contributing to better risk management.
- We feel that the 20% threshold may be too low given the second order nature of any resultant inaccuracy for unit-linked business.
- A simpler approach than one based on target allocations would be more practical and may not, subject to justification, be materially misleading.

Key points in draft responses

17. Interest rate risk

- The current calibration can underestimate the interest rate risk in some situations.
- Our view is that the principal components analysis may be feasible, the rolling window technique is not a sound method for this purpose, and the additive approach is not reasonable.

18. DTL and DTA calculation

- LAC DT should be calculated in line with the principles of IAS12, applying the relevant fiscal rules of the countries in which businesses operate.
- We suggest that any projection of post-stress profits arising should not be arbitrarily limited in term.
- In projecting profits, businesses should consider the impact of stresses and management actions that can be taken to restore capital and profitability positions.
- The LAC DT should not be limited to the net existing deferred tax losses. This effectively assumes that no future profits would be earned which is not realistic or in line with Solvency II's general assumption of ongoing business.

Key points in draft responses

19. Risk margin

- The current specification of the risk margin is inappropriate, in particular for long term life insurance business where the methodology and assumptions result in an excessive risk margin.
- The current risk margin calculation is excessively volatile with respect to interest rates.
- The prescribed cost of capital (6%) is excessive; consideration should be given to linking it to the level of long term interest rates.
- Risk dependence over time should also be considered by introducing a time dependant scaling factor.

20. Comparison of own funds in insurance and banking

- More favourable treatment of Principal Loss Absorbency Mechanisms under CRR than under Solvency II is not justified by differences in true risk exposures

Key points in draft responses

21. Capital instruments only available as tier 1 up to 20% of tier 1

- The limit of 20% introduced by Article 82(3) of the Delegated Regulation introduces the idea of sub-tiers which was deleted by the Council and the Parliament during Solvency II negotiations.
- The limit introduces unnecessary complexity in dealing with own fund items.
- If the limit were removed, the restriction should not be retained on the use of lower quality transitional own funds.