Variable Annuities and group supervision

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EIOPA Report on Variable Annuities – Why?

- Are VAs so different from other insurance product to deserve specific supervisory focus? (*questions were raised in public consultation*)
- Variable annuities (VAs) are unit-linked life insurance contracts with investment guarantees which, in exchange for single or regular premiums, allow the policyholder to benefit from the upside of the unit but be partially or totally protected when the unit loses value
- Guarantees offered may vary considerably (death, withdrawal,...) since many different products may fall under the common wide name of VAs
- Guarantees offered to policyholders imply an increase of risks for insurers. Insurers can manage those risks in different ways, usually through an hedging programme; reinsurance and/or the purchase of complex and customized structured product could be used as well. VAs can also be "naked", i.e. not assisted by a specific management of the guarantees but treated instead as any other insurance business

EIOPA Report on Variable Annuities – Why?

- VAs business employs complex risk management processes, hedging processes, high levels of capital and need of qualified staff. Usually, the “group” dimension is essential to manage this business efficiently, e.g. by using single hedge platform.
- In EU usually VAs are sold by large insurance groups either by their local subsidiaries or by specific subsidiaries dedicated to that business underwriting in several Member States, through freedom of establishment or freedom of service

These recent developments and increased complexity raise new kinds of issues for insurers and supervisors, and also for policyholders

EIOPA Report on Variable Annuities

- EIOPA Report on VA published in April 2011, after a public consultation period ended in January 2011
- The Report aims at building a supervisory standard for an effective and comprehensive supervision on issues related to VAs business, with the aim of ensuring a sound management of insurance undertakings/groups
- The Report does not address Consumer Protection issues: a specific EIOPA Report is currently under development

EIOPA Report on Variable Annuities

- The Report addresses several areas:
  - Technical and actuarial issues
  - Governance issues
  - Group/colleges issues
  - Systemic and macro-prudential issues risk
  - Data and information to be required
- The Report considers that Solvency II framework appropriately addresses VA supervisory issues: Solvency I is addressed in the view of a smooth transition to Solvency II

EIOPA Report –
Technical and actuarial issues

- "Substance over form" principle for Vas identification
- The Report identifies some possible relevant features (open list) for the assessment of the insurer and of the supervisor :
  - guarantees are usually linked to a fund (i.e. unit-linked product);
  - guarantees are generally external: this means they are not a fund characteristic, i.e. guaranteed and protected funds should not be considered. Funds managed through CPPI techniques should not be considered as well;
  - guarantees are individual: the investment position of the single client is guaranteed, not the value of the fund unit;
  - guarantees are explicitly and separately charged, e.g. through an additional charge on premium or a management fee.

EIOPA Report – Technical and actuarial issues

- Solvency II general principles for the calculation of technical provisions should be applied having in mind that:
  - the use of stochastic modelling process will normally be necessary;
  - a dynamic behaviour of policyholder should be a necessary assumption in the calculation of the best estimate;
  - the use of replicating portfolio techniques for calculation of technical provisions may be possible but highly unlikely;
  - calculation should be consistent with market values of options and guarantees traded in the market.

EIOPA Report – Technical and actuarial issues

- On capital requirements, Solvency II Standard Formula seems not to be sufficient due to the complexity of VA's risks: companies transacting VAs business should usually be required to use an Internal model for calculation of SCR
- It is reasonable to allow insurers to recognise the role of hedging programme when using internal models, but subject to strict limitations as set out concerning hedging efficiency.
- "Naked VAs" deserve a very careful and stringent assessment by the insurer and by supervisors, as well as an appropriate assessment of risks.

EIOPA Report – Governance issues

The Report aimed at defining common principles and best practices regarding governance including internal controls, i.e. on:

- Appropriate governance structure that ensures a clear and adequate allocation of tasks within the group,
- Appropriate risk framework for variable annuities, including management of operational risk and legal risk

The Report highlights some SII requirements particularly relevant for VAs business as well as some requirements for possible earlier application, provided that they are not against the national implementation of the current Directives.

EIOPA Report – Group and College of supervisors issues

VAs call for a stronger cooperation among supervisors both at solo level and at group level. This is because of:

- The complexity of VAs, both of the products and of the related governance. The supervisory assessment of technical provisions and of capital adequacy requires an analysis of the products sold, knowledge of local markets, etc.
- The typical business model which involves a number of different entities usually situated in different Member States (the holding company, the subsidiary that is set up to sell VAs, its branch, other actors: the local subsidiary, the traders, the computation platform, etc.)
- The split of competences between supervisors, i.e. prudential supervision which is under the responsibility of the home supervisors, and market conduct that is the responsibility of the authorities where the product is sold

EIOPA Report – Group and College of supervisors issues

- Due to the relevance of group aspects, specific recommendations have been identified for Colleges of supervisors as regards coordination for the supervision of insurance undertakings/groups providing VAs:
  - Activity of the college in the field of VAs
  - Composition of the college
- Very similar recommendations for Solvency I and Solvency II
- The Report considers also some form of permanent cooperation to be established in case cross-border VAs business model which doesn't formally feature a "group" (under the *General Protocol)*:
  - Enhanced information exchange in the establishment of branches
  - Analysis of compatibility between national general good requirements and VA features
  - "Right to warn", i.e. possibility to "use" the knowledge of the Host Supervisor for effective supervision by the Home Supervisor

EIOPA Report – Group and College of supervisors issues

Activity of the college

- The Report identifies a list of tasks for supervision on VAs for an adequate and complete supervision on VAs, and an example of attribution of tasks within the college (Annex II)
- Each college can take advantage of the list provided by the TF, so to develop a supervisory framework tailored to the group and its VAs business.
- Recommendation to sign a “coordination arrangement” in the College, if VAs business is relevant
- Recommendation to set up a “specialized team” within the college, if VAs business is relevant

Flexibility of approach to enhance effectiveness and efficiency in the supervisory activity

EIOPA Report – Group and College of supervisors issues

Activity of the college – the list of task

1. validity of contracts (legal risk)
2. modelling of those contracts for the hedging strategy
3. adequacy of the calculation of technical provisions and solvency requirement for those contracts
4. capacity for the company to limit some risks, given local laws (e.g. prevention of secondary market risk)
5. typical behaviour of policyholders concerning lapses, premiums, life, death,...
6. calculation of hedge recommendations by a platform located in another country
7. correct implementation of the computed hedge
8. transmission and transcription of in force data coming from another country
9. formal validation (e.g. Products launch) made by people who have knowledge of what happens locally
10. the apparent management structure matches the real management structure
11. group standards, if they exist, are sufficiently precise and effectively respected/implemented everywhere, all the time/at all levels

EIOPA Report – Group and College of supervisors issues

<u>Activity of the college (3)</u>

If VAs business is relevant for a specific group, the Report recommends that:

- Internal control and risk management on VAs is set as key topic on the agenda of the college
- VAs information are classified as “essential” (i.e. communicated on own initiative not only on request)
- As harmonised supervisory tool, specific information and data are exchanged for an assessment of VAs business (Chapter 7 in the Report provides a list of information and data deemed relevant for the assessment)
- Supervision is centralised already in Solvency I, i.e. leading role of Group supervisor so to ensure a comprehensive view of the business

EIOPA Report – Group and College of supervisors issues

<u>Composition of the college</u>

Group supervisor/Home Supervisors should (be able to) take advantage of the Host Supervisor's knowledge and activity, be the activity through free provision of services or via freedom of establishment:

- by enlarging the composition of the college already in a Solvency I framework (currently Host Supervisors are not part of the college)
- by considering relevant VAs business as a possible trigger for the formal setting up of a college in case there are no subsidiaries (no college exists), in addition to those already under discussion in Solvency II framework ("significance criteria for composition")

Flexibility of approach to enhance effectiveness and efficiency in the supervisory activity

EIOPA Report – a systemic issue?

- The Report considered that VAs do not currently pose a systemic risk for the wider financial system, due to the relative size of the market which could be estimated on the basis of current data available.
- The Report highlighted scarcity of specific data available on EU VAs and a steer for periodic collection of data. An ad-hoc survey was carried out on large insurers whose results are included in the EIOPA half year report (June 2011). Main points:
  - The market volume measured in technical provisions amounts to 168 bn EUR at year end 2009 and to 188 bn EUR at the end of H1/2010 in aggregate, indicating a 24% year-on-year growth
  - Most policies are single premium contracts (90.8% of gross written VAs annuities set out in the Report the survey suggests that most contracts (72.2% of gross written premiums) include a minimum death benefit

Best Disclosure and Selling Practices: EIOPA Report under development

- An EIOPA Expert Group was set up in May 2011 with the aim of establishing best disclosure and selling practices for VAs. The work should be completed by the end of October.
- Best disclosure and selling practices have to ensure that customers can make their choice on an informed basis.
- In particular, disclosure should provide:
  - ✓ general information on the insurance undertaking and the legal and supervisory regime it operates under to take account of the cross-border nature of this business
  - ✓ product specific information to address product complexity
- selling practices should:
  - ✓ focus on the customer's objectives to determine his demands and needs
  - ✓ ensure that VA are always sold on an advised basis;

Thank you

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