EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Technical Provisions

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on Technical Provisions. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and Insurance Guarantee Schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**). This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of topics as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

Milliman has produced a briefing note giving a summary of EIOPA's proposals in the CP (available here) and separate briefing notes covering each of these topics in more detail.

This briefing note covers EIOPA's proposals in relation to Technical Provisions.

EIOPA Proposals – Best Estimate

In the context of Technical Provisions, EIOPA has identified a number of issues and proposals related to the calculation of the best estimate liability (**BEL**) and the risk margin. In terms of the BEL, EIOPA has identified a number of divergent practices in the approach taken to certain aspects of the calculation that it is seeking to address.

IFRS17 ALIGNMENT

One issue that EIOPA has considered is whether it would be possible to align the Solvency II Technical Provisions with IFRS 17 calculations. It concludes that this would not be possible for several reasons such as the fact that the two regimes have different objectives and require different levels of granularity (e.g. the fact that IFRS 17 analyses annual cohorts of business) and also the fact that the IFRS 17 framework has not yet been finalised. EIOPA also specifically states that it considered whether the Premium Allocation Approach from IFRS 17 could be used as a simplification under Solvency II but that it has ruled this out for a number of reasons, including the SCR calculation challenges that could arise.

ECONOMIC SCENARIO GENERATORS

The next issue relates to divergent practices in the calibration of Economic Scenario Generators (**ESGs**), which are commonly used in the valuation of options and guarantees (where the value of the liability depends on market movements). These divergent practices include:

- Companies taking a different approach to simplifications e.g. choosing not to permit negative interest rates
- Differences in the choice of assets, taking account of the undertakings assets and liabilities
- Replication of option prices or implied volatilities - since the ESG has to be calibrated according to the EIOPA risk

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive

free rate, it is not possible to replicate both option prices and implied volatilities at the same time

Ultimately EIOPA concludes that differences in the calibration of ESGs are unavoidable as they have to be adapted to different businesses. Therefore, it considers the current regulations to be sufficient to ensure a consistent use of ESGs across member states. It does however, note that the assessment of choices made could be further harmonised through additional guidance. The CP does not go into detail on what such guidance may entail.

CONTRACT BOUNDARIES

Next, EIOPA has identified a number of different interpretations of regulations in relation to contract boundaries that may be of interest to firms writing regular premium business.

The first issue concerns paid-in premiums and whether Article 18(3) of the Solvency II Delegated Regulation means that obligations related to paid-in premiums do or do not belong to the contract after the contract boundary date. EIOPA proposes to reword Article 18(3) to make it clearer that obligations related to paid-in premiums still form part of the contract after the contract boundary date. As this is purely a clarification this should not affect many firms.

The second issue relates to unbundling and whether Article 18(3) applies to different parts of a contract only if it can be unbundled, or, whether it applies where the undertaking has different unilateral rights on each part of the contract even if it cannot be unbundled. EIOPA does not propose any changes to the current wording but it notes that *"further guidance may be helpful to ensure a common understanding of the unbundling principle for contract boundaries assessment"*.

The next issue pertains to the text in Article 18(3) surrounding whether undertakings are able to repeat individual risk assessments of the obligations relating to the insured person. The question is whether barriers to such assessments are legal in nature or wider (e.g. a technical restriction such as a lack of data) and whether such risk assessments need to be performed at contract level. EIOPA is proposing that Article 18(3) would be reworded to make it clear that insurers only need to consider the *"right"* to perform such an assessment. This would clarify that the correct interpretation of the requirements is that contract boundaries should not be applied where the insurer can only reprice in such a way that the premiums fully reflect the risks and where there is a contractual/legal barrier that would prevent the insurer from performing an individual risk assessment prior to repricing. Again, as this is more of a clarification, it should not affect many insurers.

In terms of Expected Profits in Future Premiums (**EPIFP**), EIOPA notes that the current definition of EPIFP does not reflect the real impact of future premiums on own funds for three reasons:

- EPIFP do not fully consider loss making policies as loss making policies may only be offset against profit-making policies within the same homogeneous risk group
- EPIFP do not take reinsurance and Special Purpose Vehicles (**SPVs**) into consideration
- EPIFP are calculated before taxes

To address these issues, EIOPA proposes to make a number of amendments to Article 260 of the Solvency II Delegated Regulation. In Article 260(2), EIOPA will now refer to the "*gross expected profit or loss included in future premiums"*. It also proposes to amend Article 260(4) by clarifying that *"Profit-making homogeneous risk groups shall be used to calculate gross expected profits in future premiums and loss-making homogeneous risk groups shall be used to calculate gross expected losses in future premiums".* EIOPA also proposes to add two new paragraphs to Article 260 to clarify how to allow for reinsurance and SPVs in calculating the *"net expected profit or loss in future premiums"*. EIOPA does not propose any change to consider tax.

It is also worth noting that EIOPA has included a question for stakeholders in the CP on whether splitting homogeneous risk groups into profit-making and loss-making groups would introduce a burdensome new calculation. It wants to know if stakeholders consider that the same group could include both profitable and loss-making business and still be considered homogeneous.

Lastly in relation to the contract boundary sub-section of the CP, EIOPA notes that future profits related to future cash inflows, particularly in relation to unit-linked business, could be considered as being similar to EPIFP but that this topic is largely unexplored. EIOPA therefore proposes to add a definition of *"the gross expected future profit or loss from servicing and management of funds"* to Article 1 of the Solvency II Delegated Regulation (to avoid undue burden, EIOPA does not propose to require a calculation on a net basis). It is likely that such an amount, once defined, would need to be disclosed on a regular basis. Therefore, this is something that companies writing unit-linked business may wish to provide feedback on, especially if they may feel such information is already partly available in the Quantitative Reporting Templates for Technical Provisions where technical provisions for unit-linked business are already identified or if they feel the production of such information may be overly burdensome.

FUTURE MANAGEMENT ACTIONS

Article 23 of the Solvency II Delegated Regulation covers future management actions (**FMAs**) and the criteria that need to be satisfied for their use. In the CP, EIOPA notes that the lack of a definition of FMAs has led to different interpretations of Article 23 and its requirements. The main issue identified is the link between FMAs and undertakings' business plans. Some insurers have assumed that actions already foreseen in the business plan should not be considered as FMAs and are therefore not under the scope of Article 23. Other insures take

a different view. As a result, EIOPA proposes to add a definition of FMAs to Article 1 of the Solvency II Delegated Regulation, as follows:

"'future management action' means any action that the administrative, management or supervisory body of an insurance or reinsurance undertaking may expect to carry out under specific future circumstances".

EXPENSES

In terms of expenses, EIOPA notes that the main issue is that Article 31(4) of the Solvency II Delegated Regulation states that, *"Expenses shall be projected on the assumption that the undertaking will write new business in the future."* EIOPA suggests that this assumption may not be appropriate, for example, for companies that are closed to new business. Therefore, EIOPA proposes to amend Article 31(4) to state that, *"Expenses shall be projected taking into account the decisions of the administrative, management or supervisory body of the undertaking with respect to writing new business"*. EIOPA justifies this change on the basis that assuming new business will be written when this is not the case would lead to a non-realistic calculation of the BEL that would be less prudent. EIOPA acknowledges that the Technical Provisions are intended to reflect a transfer value and that some parties might argue that not allowing for new business could depart from this assumption if an acquirer were to make some allowance for new business or synergies with other business. However, EIOPA argues that in practical terms, the expenses of the undertaking and the fact that it does not write new business would probably be considered in any transaction so this is not a major concern. It will be interesting to see if EIOPA receives much feedback on this proposal.

EIOPA has also asked stakeholders if they consider that the proposed wording may introduce barriers to entry for new undertakings.

EIOPA also proposes to clarify the wording of Article 31(1). Currently, this Article refers to *"expenses incurred"* and some stakeholders had interpreted this to mean that expense assumptions should be based on historic expenses. EIOPA proposes to change this wording to refer to *"expenses to be incurred"* to make it clearer that assumptions should consider expected future expenses. Once again, as this is purely a clarification we would not expect many firms to be significantly affected by this proposal.

VALUATION OF OPTIONS AND GUARANTEES

EIOPA notes that the modelling of dynamic policyholder behaviour is expected for contracts with options and guarantees, but that static approaches can be used if justified with empirical evidence. Such dynamic modelling is intended to reflect the fact that policyholders might be less likely to lapse if their guarantee is more valuable. EIOPA notes that there are several reasons why dynamic policyholder behavior might not be modelled. These include a lack of data and evidence of how policyholders have historically reacted to extreme financial conditions. EIOPA also notes that there can be difficulties in splitting lapse experience into a static component that does not vary with financial conditions and a dynamic component that does. This can lead to a double count if parts of the dynamic experience are already factored into the derivation of the assumption for the static component. EIOPA goes on to say that the use of dynamic policyholder behaviour is highly dependent on the jurisdiction and that the lack of data cannot be considered to be a good reason to avoid dynamic policyholder behaviour modelling. EIOPA concludes that no changes are required in the Delegated Regulation but it notes that harmonisation could be achieved via additional guidance.

Risk Margin

In the CP, EIOPA sets out a number of potential issues related to the risk margin along with its views on these issues. The first issue relates to whether the risk margin is consistent with the valuation of transferred assets and liabilities. EIOPA notes that it has collected information to perform such analysis. It concludes that the data available was quite limited but that there was no evidence of a systemic mis-calibration of the risk margin.

The next issue covered is in relation to assumptions underlying the reference undertaking. In particular, at present a reference undertaking is assumed to take on the liabilities and take steps to de-risk the asset portfolio. As a result, neither the volatility adjustment (**VA**) nor the matching adjustment (**MA**) can currently be used in calculating the risk margin. In the CP, EIOPA devotes several pages to analysing the 'pros' and 'cons' of making a change to this approach but concludes that on balance no change is required.

The third issue discussed relates to the use of a fixed cost of capital rate of 6%. EIOPA notes that the risk margin is very sensitive to changes in interest rates and that it had previously analysed the sensitivity of the cost of equity to interest rates as part of the 2018 interim review of Solvency II. EIOPA concludes that the decrease in interest rates since 2011 is not a convincing argument on its own to decrease the cost of capital.

The final issue pertains to the appropriateness of assumptions underlying the 6% cost of capital rate such as the absence of leverage and the derivation of the equity risk premium. EIOPA notes that it *"thoroughly reviewed the derivation of the CoC rate in 2017 and 2018 and set out the results in the Second set of Advice to the European Commission on specific items in the Solvency II Delegated Regulation"*. It concludes that it has *"no evidence or indications that the conclusions drawn in the 2018 are not valid anymore. Therefore, no additional analysis was carried out."* As a result no changes are proposed here.

Ultimately, following on from its conclusions set out above, EIOPA does not propose any change to the risk margin calculation. However, it does ask a number of questions of stakeholders, as follows:

- If their experience is consistent with that of EIOPA in that the risk margin can be more sensitive to interest rate changes for longer term business
- What is their view on assumptions underlying the reference undertaking where the original undertaking applied the MA or VA and whether any of the pros and cons set out by EIOPA in considering various approaches for the risk margin are inconsistent with the stakeholders' experience.
- Whether there are any approaches to the calculation of the risk margin that stakeholders believe should be considered.

Summary

In Summary, EIOPA proposes to make the following changes to the Solvency II requirements:

- Edits to Article 18 of the Solvency II Delegated Regulation to make it easier to interpret contract boundary requirements
- Edits to Article 260 of the Solvency II Delegated Regulation to more closely align the concept of EPIFP with the impact of future premiums on own funds
- The introduction of a definition for *"the gross expected future profit or loss from servicing and management of funds"* and possible disclosure requirements related to this
- The introduction of a definition of future management actions to ensure a consistent interpretation
- A change in Article 31(4) of the Solvency II Delegated Regulation to state that expenses should reflect the decisions of the board with respect to writing new business (rather than assuming new business will be written as set out in the current requirements).
- An edit to Article 31(1) of the Solvency II Delegated Regulation to clarify that in setting expense assumptions companies should take account of expenses that will be incurred in future as the current wording is less clear on this point.

Furthermore, EIOPA acknowledges that additional guidance may be beneficial in the following areas to ensure a common understanding (but has not issued any proposals as to what this guidance might include):

- Calibration of ESGs
- Unbundling requirements in the context of contract boundaries
- The allowance for dynamic policyholder behavior when valuing options and guarantees

Finally EIOPA has identified a number of areas where no changes are proposed. In particular, despite several stakeholders raising concerns with the risk margin calculation and the assumptions underlying this, no changes are proposed. Also, EIOPA notes that it does not propose to attempt to align the calculation of Solvency II technical provisions with IFRS 17 principles.

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