

# Solvency II Delegated Regulations 2018 Interim Review

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The amendments to the Solvency II Delegated Regulations resulting from the 2018 interim review have now been published in the Official Journal of the EU. The majority of changes entered into force on 8th July 2019 with some specific changes not entering into force until 1st January 2020.

This briefing note summarises some of the main changes arising from these amendments, but be sure to look at the full detail of the amendments which can be found in the Official Journal<sup>1</sup>.

## Loss-absorbing capacity of deferred taxes

In order to standardise the assumptions used for the projection of future profits, and hence reduce the degree of subjectivity in the calculation, additional principles for the standard formula calculation of the loss-absorbing capacity of deferred taxes ("LACDT") have been included as follows:

- Undertakings are required to have a deferred taxes policy under the risk management system. The actuarial function or the risk management function shall assess and validate the underlying assumptions used for the projection of future profits.
- In the Solvency and Financial Condition Report ("SFCR") and Regular Supervisory Report ("RSR"), undertakings must clearly explain the amount of deferred tax asset and the extent to which it has been recognised. They must also show how they calculate their deferred tax assets and LACDT and demonstrate that it is likely that they can be utilised in the future.
- Undertakings must take into account:
  - Time limits relating to carry-backs and carry-forwards;
  - The magnitude of the loss from the shock and its impact on the undertaking; and
  - The increased uncertainty in future profits post-shock.

- Assumptions should not be more favourable than those used for the valuation of LACDT pre-shock.
- New business sales in excess of those projected for the undertaking's business planning may not be assumed, and they may not be projected beyond the horizon of the business plan (or beyond a maximum of 5 years).
- Post-shock rates of return on investments should be assumed to be equal to the forward rates derived from the relevant risk-free interest rate term structure, unless the undertaking can provide credible evidence of likely returns in excess of this.
- Undertakings may assume the implementation of future management actions post-shock provided they comply with Article 23 of the Delegated Regulations on future management actions.

These amendments will enter into force on 1<sup>st</sup> January 2020.

## Look-through approach

Under the interim review, the look-through approach has been extended to apply to related undertakings<sup>2</sup> where:

- their main purpose is to hold or manage assets on behalf of the participating (re)insurance undertaking;
- they support the operations of the undertaking's investment activities, following a specific and documented investment mandate; and where
- they do not carry on any other significant business.

Additionally, the simplified application of the look-through approach based on the target underlying asset allocation of a collective investment undertaking or fund can now be applied based on the last reported asset allocation. This is allowed when exposures and risk are not expected to vary materially over a short period of time (and the target asset allocation is not available).

Currently a maximum threshold of 20% of the total value of assets applies for the use of data groupings under the look-through approach. The changes to the delegated regulations now exclude funds which back unit-linked and index-linked obligations

<sup>1</sup> [COMMISSION DELEGATED REGULATION \(EU\) 2019/981](#)

<sup>2</sup> A related undertaking is either a subsidiary undertaking or other undertaking in which a participation is held, or an undertaking linked with another undertaking by a relationship as set out in Article 22(7) of [Directive 2013/34/EU](#)

where policyholders fully bear the market risk from the determination of this 20% threshold.

Further amendments ensure that collective investment undertakings and investments packaged as funds are treated consistently at solo and at group level.

These amendments entered into force on 8<sup>th</sup> July 2019.

## Counterparty default risk and risk-mitigating techniques

The main changes and clarifications in the counterparty default risk calculation were the following:

- Credit derivatives covered in the spread risk sub-module are not in scope for the counterparty default risk sub-module.
- The loss-given-default can now be calculated on a counterparty level for contractual netting agreements where several derivatives under the same contract represent exposure to the same counterparty.
- The calculation of the exposure to qualifying central counterparties (“CCP”) has now been defined under the delegated regulations.
- A hedging strategy may be used as a risk-mitigating technique even if all the individual contracts do not comply with all the requirements for risk-mitigation techniques, so long as the entire hedging strategy does.
- Certain hedging strategies may now be recognised as risk-mitigation techniques where even replacement or adjustment takes place more often than once per week, if there would be a material adverse impact on the solvency position without replacement or adjustment.
- The minimum initial contractual maturity for a risk-mitigation technique is specified as one month when using financial instruments and as three months when using reinsurance or special purpose vehicles.
- Where a reinsurer breaches its SCR, the reinsurance arrangement may be partially recognised for up to six months unless it becomes clear during the six months that the reinsurer is unlikely to be able to restore compliance with the SCR within that period. If a reinsurer breaches its MCR then the risk-mitigation technique may no longer be recognised.
- The risk-mitigating effect of a partial guarantee for type 2 mortgage loan exposures may be recognised but only where it is unconditionally and irrevocably guaranteed by the institutions listed in Article 180(2)(a)-(d).

These amendments entered into force on 8<sup>th</sup> July 2019.

## Market risk

The most significant changes to the market risk module were as follows:

- Criteria have been defined for unlisted qualifying equity portfolios to be considered as type 1 exposures.
- A capital charge of 22% should be applied to long-term equity investment. A portfolio may be classified as long-term equity investment if it meets the conditions set out in the new Article 171a.
- The credit quality step for bonds and loans for which a credit assessment by a nominated External Credit Assessment Institution (ECAI) is not available will be 2 or 3 based on either the insurance or reinsurance undertaking's own internal credit assessment or on a third party's approved internal ratings model where the third party co-invests in the unrated bond or loan with the insurer.

We have explored these topics in detail in sections 4.1 to 4.3 of our May 2019 report, “[Solvency II Under Review: Part 3](#)”.

- In the calculation of the currency risk sub-module of the consolidated group SCR in the standard formula, a local currency other than the one used for the preparation of the consolidated accounts may be used if a material amount of the consolidated technical provisions or the consolidated group own funds is denominated in that currency.

Other, less material, changes to the market risk module are set out in full detail in the Official Journal.

These amendments entered into force on 8<sup>th</sup> July 2019.

## Classification of own funds

Conditions for the triggering of the principal loss absorbency mechanism of restricted tier 1 instruments have been defined as follows:

- Partial write-down is permitted on a straight-line basis when the SCR has been breached for three months provided that neither the MCR nor 75% SCR coverage are breached.
- If SCR coverage worsens in the next three months but still does not breach the MCR or 75% SCR coverage, then further write-down is required. This is repeated every 3 months until compliance with the SCR is re-established.
- If the MCR or 75% SCR coverage is breached, then there should be a full write-down.
- Where an undertaking can show that the write-down would create a tax liability that would significantly adversely affect their solvency position, then provided certain other conditions are met, the compulsory write-down may not be triggered.

The amendments also allow for repayment or redemption of own-fund items before five years after issuance where an unforeseen regulatory or tax event occurs.

These amendments entered into force on 8<sup>th</sup> July 2019.

## Simplified calculations under the standard formula

There have been a number of changes to simplifications under the standard formula, noting that for all simplified calculations, Article 88 on proportionality must be complied with.

### LAPSE RISK

Homogenous risk groups may be used for the calculation of the simplified SCR for all lapse risk sub-modules provided they comply with the requirements of Article 35(a)-(c).

### SPREAD RISK AND MARKET RISK CONCENTRATION

A simplified calculation has been introduced whereby, if a single nominated ECAI is required, all investments not covered by this ECAI can be assumed to be of credit quality step 3 if the following criteria are met:

- credit assessments from the nominated ECAI are available for at least 80% of the total value of bonds.
- any investments not covered by the nominated ECAI are bonds or similar investments with a fixed redemption payment at or before maturity and with regular fixed or floating rate interest payments.
- the bond is not a structured note or collateralised security.
- the investment does not cover profit participating liabilities, unit-linked or index-linked liabilities, or liabilities for which the matching adjustment is used.

### COUNTERPARTY DEFAULT RISK

Where the standard deviation of the loss distribution of type 1 exposures is less than or equal to 20% of the total losses-given-default on all type 1 exposures, a simplified calculation of five times the standard deviation may be used to calculate the capital requirement.

The simplified calculations for the risk-mitigating effect of reinsurance arrangements or securitisations under Articles 107 and 108 may not be used if the best estimate of amounts recoverable is negative.

For a reinsurance arrangement which affects only one line of business, a simplified calculation for the risk-mitigating effect of the reinsurance arrangement on underwriting risk has been introduced.

A simplified calculation of the loss-given-default for reinsurance or insurance securitisation has also been introduced.

### NATURAL CATASTROPHE RISK

Groupings of risk zones may be used for the calculation of the sum insured for the natural catastrophe risks provided that all of the risk zones within a group are situated in the same region as set out in Annexes V-VIII. The highest zonal risk weight within the group (as set out in Annex X) will be the risk weight for that group.

### FIRE RISK

The fire risk capital requirement may be calculated as the maximum of the largest industrial, commercial or residential fire risk concentrations. These concentrations are based on the maximum of the total exposure within the perimeter of the 5 largest exposures. For residential fire risk, this concentration is subject to an underpin based on the market share of the undertaking.

These amendments entered into force on 8<sup>th</sup> July 2019.

## Non-life underwriting risk

### VOLUME MEASURE FOR PREMIUM RISK

The definition of  $FP_{future}$  has been expanded so that, for multi-year contracts where the initial recognition date falls in the following 12 months, it is equal to 30% of the expected present value of premiums to be earned under segments, after the following 12 months.

### PARAMETERS FOR PREMIUM AND RESERVE RISK

The standard deviation parameters for gross premium risk and for reserve risk have been updated for the following segments:

- Non-life:
  - Credit and suretyship insurance and proportional reinsurance;
  - Legal expenses insurance and proportional reinsurance; and
  - Assistance and its proportional reinsurance.
- NSLT Health:
  - Medical expense insurance and proportional reinsurance;
  - Workers' compensation insurance and proportional reinsurance; and
  - Non-proportional health reinsurance.

These updates will apply from 1<sup>st</sup> January 2020.

### NATURAL CATASTROPHE CONTRACTUAL LIMITS

For each peril, if the gross loss for a zone calculated using the standard formula approach is greater than the maximum gross exposure taking account of the specific policy conditions, then the undertaking can cap its maximum loss for that zone at that maximum gross exposure.

### MARINE RISK

The word “tanker” has been replaced with “vessel” in order to expand the scenario to include all insurance entities writing marine business. A threshold has been introduced such that vessels with an insured value of less than €250,000 are not included in the scenario.

### MARINE, FIRE AND AVIATION RISK

The largest risk exposures within the marine, fire and aviation risk sub-modules should be identified on a net of reinsurance basis (rather than the current gross of reinsurance basis). Only reinsurance arrangements which would pay out in the event of insurance claims related to the vessel, platform, aircraft or buildings should be taken into account. If, on a net basis, the calculated capital requirement does not sufficiently capture the marine, aviation or fire risk to which the undertaking is exposed, then the calculation should be carried out on a gross basis.

Apart from the updated parameters for premium and reserve risk, these amendments entered into force on 8<sup>th</sup> July 2019.

## Other

- A number of tidy-ups and corrections of minor items have been applied within the text. For instance an edit has been made to the wording of Article 18 on contract boundaries.
- Under the general provisions, further specifications have been added on the methodologies, principles and techniques for the determination of the relevant risk-free interest rate term structure.
- Criteria have been specified for recognising bonds and loans which are guaranteed by regional governments and local authorities as exposures to the central government in the standard formula calculation.
- Methodology has been added for the calculation of the adjustment factor for non-proportional reinsurance as an undertaking-specific parameter where the insurance or reinsurance undertaking has a stop-loss treaty in place.

## How Milliman can help

Our consultants have been involved in advising our clients on Solvency II issues since its conception. We have undertaken a range of work for clients across all three pillars of Solvency II. Our services include:

- Assessment of the impact of 2018 review on insurance company's balance sheets;
- Independent review and gap analysis of Solvency II requirements;
- Independent Review of Solvency II balance sheet, technical provisions and SCR;
- Extensive experience of modelling projected balance sheets, technical provisions and SCR calculations;
- Assessment of standard formula SCR appropriateness;
- Solvency II training; and
- Discharging statutory roles such as Head of Actuarial Function and Reviewing Actuary.

Milliman has developed a Solvency II Compliance Assessment Tool ([link](#)). The tool enables both life and non-life (re)insurance companies to easily monitor and assess their level of compliance across all three pillars of Solvency II and is updated regularly for changes to Solvency II requirements.

Other software available to support companies in the ongoing Solvency II requirements include:

- Milliman Star Solutions - Vega®: An automated Pillar 3 reporting and standard formula aggregation system ([link](#))
- Milliman Star Solutions - Navi®: A liability proxy modelling tool ([link](#))
- Milliman Outsourcing Compliance Tool ([link](#))

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