HYMANS ROBERTSON

Solvency II newsflash

Regulatory round-up

After a prolonged period of relative quiet in the world of insurance regulation, October and November saw a deluge of publications. In this Newsflash we pick out the highlights.

The main regulatory publications in Q4 2017 were:

- A report by the Treasury Committee on insurance regulation.
- A consultation from the European Insurance and Occupational Pensions Authority (EIOPA) on changes to the Delegated Acts, the disappointing headline from which was that EIOPA proposes to recommend that no changes be made to the Risk Margin calibration.
- A consultation paper by the Prudential Regulation Authority (PRA), initiated by the Treasury Committee's report.
- A consultation from the PRA on the Volatility Adjustment.
- A consultation from the PRA about how firms allow for the Matching Adjustment in their internal models.

We discuss the report from the Treasury Committee and the implications for the PRA – including the implications of EIOPA recommending no change to the Risk Margin calibration – in a separate article. This article rounds up the remaining developments.

EIOPA consultation on changes to the Delegated Acts

On 6 November, EIOPA published its Consultation Paper on its second set of advice to the European Commission on the Solvency II Delegated Acts. Aside from the recommendation that no changes are made to the calibration of the Risk Margin – which we discuss in a separate article – the highlights of the consultation are summarised in the following table:

Area	Current situation
Longevity risk	No change to the calibration of the Standard Formula longevity stress (20% instantaneous reduction in mortality rates).
Mortality risk	A recommendation that the Standard Formula mortality stress test be changed to a 25% instantaneous increase in mortality rates (from 15% at present).
Interest rate risk	A proposal to address the main perceived weakness of the Standard Formula in this area during periods when interest rates are low. As the rules currently stand, the size of the interest rate shock is proportional to the current risk-free rate. EIOPA has proposed various alternatives to this, such as specifying a minimum 200bps shock.
Unrated debt	EIOPA proposes that unrated bonds and loans should have the same treatment as A-rated securities in the Standard Formula, provided that firms can demonstrate they satisfy a long list of criteria.
Unlisted equities	Similar to the proposal on unrated debt, firms will be able to treat unlisted equities as "Type 1" provided they can demonstrate that the holding meets various requirements.
Counterparty default risk	EIOPA has proposed some simplifications to the calculation of counterparty default risk in the Standard Formula.
Look through principle	Simplified approaches (e.g. grouping assets or using a fund's target allocation) may be used for any assets backing certain unit-linked or index-linked products, and for up to 20% of the firm's remaining assets. Under the current rules, simplified approaches may be used for 20% of a firm's total assets (including those backing unit-linked business)
Currency risk	A proposal for firms to be able to assess currency movements against, for example, the currency in which the majority of their technical provisions are denominated, even if this is not the same currency as used for financial reporting.
"Restricted" Tier 1 capital items **e.g. subordinated debt or preference shares that meet the criteria to be classified as Tier 1**	Under the current rules, "Restricted" Tier 1 items can make up no more than 20% of an insurer's total Tier 1 capital. EIOPA has proposed two options to the Commission: • No change. • Remove the 20% limit but strengthen the criteria for items to qualify as Tier 1.

The consultation closes on 5 January, with EIOPA due to provide its advice to the Commission by 28 February.

PRA consultation on the Volatility Adjustment

The PRA recently launched a consultation on some changes to the Supervisory Statement SS23/15 on regulatory approval for use of the Volatility Adjustment (VA). Some of the changes amount to clarification to areas where the broad policy was already established – such as the requirement that firms must be able to earn the VA in practice. There are also some new requirements, which perhaps reflect a general scepticism about the VA from the PRA, a particular example being regulator's comment on the risk of undervaluing financial guarantees.

Some of the more substantive areas relate to:

- Under-valuation of financial guarantees: the PRA has stated that there is a risk that using the VA could result in financial guarantees being inadequately provisioned for. When evaluating hedging decisions, firms will be expected to use valuation bases that appropriately reflect their risk profile, rather than necessarily using their Solvency II balance sheets.
- Capital requirements: The PRA has clarified that use of the VA can result in a smaller Solvency Capital Requirement (SCR); particularly for risks such as longevity risk where the size of the capital requirement depends on the liability discount rate. The PRA expects firms' Own Risk and Solvency Assessments to capture any risks arising from the use of the VA that are not captured in the SCR.
- Earning the VA in practice: Where a firm is reliant on the yield from assets with an uncertain return, or on future reinvestment of asset proceeds, the firm will need to demonstrate in its application how it will monitor and manage these risks.

The consultation on the changes is open until 9 February 2018.

Ross Evans, Head of Insurance Investment and ALM

The PRA seems to be sceptical about the appropriateness of using the VA, particularly in the context of valuing guarantees. Firms should perhaps expect an increase in scrutiny of their ALM practices for lines of business where the VA is applied. It would seem advisable to start considering how policies for monitoring and managing the risks associated with financial guarantees and any risks that could lead to assets not earning the VA in practice.

The continued silence from the PRA on a dynamic VA is deafening, albeit that the silence will be ringing in its own ears in the wake of the recent dressing down from the Treasury Committee.

PRA consultation on modelling the Matching Adjustment in internal models

The PRA is also proposing to refine its guidance on how firms treat the Matching Adjustment (MA) in internal models – and is consulting on a draft supervisory statement on this topic.

The tone of the supervisory statement reinforces the view that the PRA is not a big fan of the Fundamental Spreads (FSs) that are used to calculate the MA; particularly their stability to changes in credit spreads. During the run-up to the Solvency II, the PRA warned firms against using "mechanistic" approaches to modelling how the FSs would change under stress (i.e. using EIOPA's methodology to calculate the FSs in stressed conditions). The draft supervisory statement reiterates this view, and presents several justifications for it.

Interestingly, one of these justifications is that, when attempting to model a permanent increase in default rates, it is inappropriate to use the EIOPA approach of looking at an average of the last 30 years' data. Using this approach to consider what the Technical Provisions may be in one year's time will result in FSs that are weighted averages of 29 years of "benign" default experience and only one year of "stressed" default experience – which does not capture the assumption that the increase in default experience is permanent.

Stephen Makin, Head of Risk and Capital

The PRA is arguing that modelled changes to default rates under stress should be regarded as permanent. This logic is sound, but it has implications for other risks where best estimate assumptions are based on averages of the last few years' observed experience, as is commonly the case with baseline mortality and longevity assumptions. The logical extension of the PRA's argument in the context of fundamental spreads, when applied to determining capital requirements for baseline mortality or longevity risk, is that it is not appropriate merely to see how much your best estimate assumption would change in light of one year's extreme experience. To do so would ignore a fundamental piece of information – that, by hypothesis, the change in experience is permanent. That permanence must be factored into the capital requirements.

The draft supervisory statement also covers:

- Detail on how firms should model the risk that a stress event leads to a breach of the MA qualifying conditions which the firm is unable to rectify within the required two month period.
- Various other points on modelling, such as the necessary granularity, requirements relating to use of historical data and an expectation that firms will model the full transition matrix for downgrade and default risk.
- An expectation that firms will consider the risk that a longevity shock leads to a breach of the MA qualifying conditions.

Andrew Scott, Senior Life Consulting Actuary

We don't anticipate any immediate action for firms with approved internal models as a result of this supervisory statement. However it'll be of interest to any firms considering or in the process of applying for internal model approval. It's also likely to be something that firms will need to take into account when they come to apply for permission to make changes to previously-approved models.

How should firms respond?

Although regulatory developments are unlikely to generate the sort of frenetic activity within firms that they did during the run up to Solvency II, there are still changes happening. The PRA now seems to be involved in two broad work streams; one dealing with how it responds to the criticism it has faced from MPs and a second relating to tweaking the rules in light of the experience gained now that Solvency II has been in force for two years. This second work stream is unlikely to require any urgent action from firms that already have all the regulatory approvals they require – but the changes will need to be considered when firms apply to make fresh applications to use an internal model, the VA or the MA, or when they apply to make changes to their approvals.

Hymans Robertson has a wealth of relevant Solvency II experience, from risk and capital optimisation under Solvency II, through to broader areas such as model calibration and validation in the areas of longevity risk, credit risk, and dependency & aggregation.

Our consultants would be delighted to support you. If you would like more information or advice, please get in touch

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