

EIOPA Solvency II technical specifications: Solvency Capital Requirements

October 2012



The release of updated technical specifications by EIOPA brings many of the requirements for future quantitative assessments in line with the draft Solvency II Level 2 Implementing Measures

INTRODUCTION

On 18 October 2012, the European Insurance and Occupational Pensions Authority (EIOPA) released Part 1 of the technical specifications for the Solvency II valuation and Solvency Capital Requirements calculations. This document, along with the accompanying annexes, updates the approach and calculations that firms should follow under future quantitative assessments, and specifically the upcoming Long Term Guarantee Assessment (LTGA).

EIOPA highlights that these technical specifications make use of ad hoc simplifications for the purposes of impact assessments and, as such, should not be considered as a complete implementation of the Solvency II framework.

Part 1 of the technical specifications sets out the approach that firms should follow in respect of:

- the valuation of assets and calculation of the best estimate liabilities and risk margin;
- the structure and calculation of the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR);
- the treatment of participations;
- the classification and eligibility of own funds; and
- the treatment of groups.

To assist you in digesting the updated technical specifications, Milliman has prepared a series of summary papers, including analysis of what any changes to the requirements may mean for firms.

This summary paper covers the Solvency Capital Requirement (SCR). Further papers cover the changes in relation to the valuation of assets and liabilities, Minimum Capital Requirement (MCR), Own Funds and Groups. The overview section which follows is common to each of our papers.

GENERAL OVERVIEW OF THE TECHNICAL SPECIFICATIONS

While the technical specifications include a number of changes since the version used for QIS5, many of these changes have been introduced to bring the technical specifications into line with the draft Level 2 Implementing Measures (DIM) produced by the European Commission in October 2011. Although this DIM text has not been officially published, it has been made widely available as a basis for Solvency II implementation, and, as such, few of the changes should come as a surprise to firms.

The introduction to the current technical specifications highlights that a number of sections have been deliberately not included. EIOPA does not consider that these provide key information for the purposes of the quantitative tests that may be launched in the coming months. These include relevant parts of the SCR calculation such as sections on:

- internal models;
- undertaking specific parameters; and
- certain group-specific components including the combination method, the treatment of Participations, Ring Fenced funds and internal models for group calculations.

EIOPA has commented that the first part of the technical specifications does not cover areas which relate to the Long Term Guarantee (LTG) package (including the matching adjustment and counter-cyclical premium) which are still the focus of trilogue discussions between the European Parliament, European Commission and Council of the European Union. As such, details of the discount rate to be used for calculations of the technical provisions are due to be covered in a second part of the technical specifications to be released at a later date.

SOLVENCY CAPITAL REQUIREMENTS

The overall specifications to be used for calculating the SCR under the standard formula in future quantitative assessments follow the same modular approach as used for QIS5. While this has been updated to replace the illiquidity risk sub-module with a counter-cyclical premium (CCP) risk sub-module, the accompanying text comments that this new sub-module should be disregarded for the quantitative assessments at this stage. Consistent with this, no details on the CCP risk are included under the market risk module of the SCR within the technical specifications.

For the scenario-based modules, the calculation of capital requirements should now be based on the impact on the level of Basic Own Funds (BOF) rather than net asset value. However, this change is presentational, as the definition of the two measures is consistent, bringing the technical specifications into line with the DIM text.

Future discretionary benefits

The specifications include new details on the inclusion of future discretionary benefits in the calculation of the net SCR. These specify that the value of future discretionary benefits included in technical provisions should account for the impact of the relevant stress on future profits. The technical provisions should reflect the related management actions in respect of the assignment and distribution of future discretionary benefits under the relevant scenario.

Where management actions are included, firms are also required to consider:

- any legal, regulatory or contractual requirements on the assignment and distribution of future discretionary benefits; and
- the firm's current best practice applied in the assignment and distribution of discretionary benefits.

Therefore, the value of the technical provisions should reflect policyholder reasonable expectations and be based on realistic management actions.

Loss absorbency of technical provisions and deferred taxes

For future quantitative assessments, the adjustment in respect of the loss absorbing capacity of technical provisions and deferred taxes should be calculated using a modular approach, whereby the

adjustment is calculated separately for each relevant risk. The equivalent scenario tested in QIS5, under which all the risks covered by the standard formula were assumed to occur simultaneously, has been removed from the technical specifications.

Deferred tax asset

While the adjustment to the SCR in respect of the loss absorbency of deferred taxes is approached in a consistent way to QIS5, the technical specifications now include significantly increased levels of guidance on how this should be determined and the extent to which this adjustment should be recognised for quantitative assessments. The new text specifies that where "any adjustment results in a positive change of deferred taxes, the adjustment shall be nil".

Although the adjustment should be determined by stressing the Solvency II balance sheet and determining the consequences on the tax figures, the technical specifications permit a method using average tax rates to be used instead.

Correlations

The capital requirements calculated from the individual sub-modules are to be combined using a correlation matrix which is unchanged from that provided in QIS5.

There is a change to the correlations to be used within the market risk sub-module. Here the correlations to be used for future assessments have been updated to be consistent with the DIM text. As such, only a single correlation matrix is presented with the correlations between interest rate risk and equity, property and spread risk set to a parameter A. (A is zero when the capital requirement for interest rate risk is derived from the interest rate up stress, including the loss absorbing capacity of technical provision, and 0.5 in all other cases). The correlation between CCP risk and spread risk has been set at zero (in contrast to the -0.5 correlation between illiquidity premium risk and spread risk used in QIS5).

We note that the updated market risk correlation matrix to be used for quantitative assessments is now consistent with that set out in the DIM, parts of which were challenged by industry groups. Comments at the time from the CEA (now Insurance Europe) noted in particular that the CCP risk module should be negatively correlated with other market risk modules to reflect the fact that the CCP is a counter-cyclical tool which is activated when financial markets come under stress.

Given the adverse impact that such a change may have on firms' capital requirements, it is perhaps surprising that the technical specifications state the CCP risk should be disregarded for the quantitative assessment.

SCR – Operational Risk

The calculation of the operational risk capital charge is broken down into two components representing changes in earned premiums and technical provisions as was done under QIS5.

The calculation of the component for operational risk in respect of earned premiums has changed slightly for future quantitative assessments from that specified under QIS5. The technical specifications now permit a 20% increase in earned premium over the year from the 12 months prior to the previous 12 months before incurring additional capital, rather than 10% used for previous assessments (and as set out in the DIM text).

We note that the calculation of operational risk capital under the standard formula has often been criticised for not adequately reflecting the operational risk exposure of firms, particular for firms with volatile premium experience.

While still disconnected from the underlying operational risk drivers of many firms, the change to the formula would be expected to reduce the impact of fluctuating premiums on the risk capital firms need to held, as well as the overall level of operational risk capital.

The rationale for this change is unclear, as we would not expect this to be a significant component of future quantitative assessments, nor does it appear to represent a simplification for the purposes of performing such assessments. As such, this may reflect current thinking on the form of Solvency II.

The technical provisions used for the calculation of operational risk capital should exclude the risk margin (as under QIS5). The technical specifications also indicate that the technical provisions should be calculated without deduction of recoverables from reinsurance contracts and SPVs.

SCR – Market risk module

A number of changes have been made to the technical specifications in relation to the calculation of the SCR market risk module in order to make this consistent with the DIM text. These include:

- updating the formula for the market risk capital requirement to reflect the use of a single correlation matrix (as noted above);
- adjusting the table of stresses to be applied to the interest rate curve under the interest rate risk sub-module;
- removing the exemption of index-linked bonds from the constraint that the absolute change in the interest rate downward scenario should be at least one percentage point (where the unstressed rate is lower than 1%, the shocked rate in the downward scenario should be assumed to be 0%); and
- renaming the illiquidity premium risk sub-module to be counter-cyclical premium risk.

At various points throughout the technical specifications, new text is included setting out the treatment of specific financial instruments in future quantitative assessments, including:

- **Callable bonds** – firms should include consideration of the fact that callable bonds and other types of interest rate structures may not be called by the issuer in the event that spreads widen or interest rates increase. This may have an impact on the duration of the asset.
- **Repo arrangements** – a repo-seller, having agreed to repurchase collateral at a future date, should take account of any risk associated with the collateral even though it is not presently holding it. A repo-lender should take account of any concentration, interest, spread or counterparty risk associated with the items exchanged for the collateral, taking into account the credit risk of the repo-seller.
- **SPV notes** – SPV notes with mostly fixed-income bond features (and rated BBB or better) should be considered under the spread risk, interest rate risk and concentration risk sub-modules. Other SPV notes should be considered as non-traded equities under the equity risk sub-module.

In addition to the above, specific changes have been made to the market risk module as set out below.

Look-through requirements

The look-through approach should be used in quantitative assessments to determine exposures in collective investment funds and other indirect holdings, such as investments in entities functioning primarily as holding entities for underlying assets. The technical specifications clarify that, it should not be applied to investments in listed equity, tradable securities or other financial instruments based on repackaged loans. Where indirect exposures are either immaterial in relation to total assets of the firm, and for holding entities with debt-to-equity ratio under 0.5, the exposure to the collective investment scheme may be treated as a Type 2 equity stress (i.e., subject to an immediate fall in value of 42%).

New text is also included in relation to the assets representing the employees' benefits liabilities. Where management of these has been outsourced, but the firm, acting as a sponsor, is liable for any loss of value of the backing assets, then the outsourcing arrangement should be looked-through for the calculation of the market risk capital charge.

Interest rate risk sub-module

The approach to calculating the capital requirements for interest rate risk is unchanged, but new text is included in the technical specifications to clarify that the interest rate stresses should apply to all interest-rate sensitive assets and liabilities (which are detailed to exclude direct property investments, equity investments, and investments in subsidiaries or participations).

The text specifies that where mark-to-market valuation techniques are used, firms may need to derive a consistent mark-to-model valuation as part of the quantitative assessment for the purposes of assessing the impact of the change in the interest rate term structure. Where this is done, the interest rate stresses should be applied to the basic risk-free interest rate (with no changes to spreads assumed under these scenarios).

Equity risk sub-module

The text in relation to the equity risk sub-module has been updated to consider explicitly short positions in equity exposures (including put options). The technical specifications state that, for future quantitative assessments, these should be netted off against long equity positions for the

purposes of determining the equity risk charge "only if the short position meets the requirements to be considered as an acceptable risk mitigation technique for the purposes of the calculation of the SCR with the standard formula".

Any other short equity exposure should be ignored in the assessment when calculating the equity stress in the equity risk sub-module of the standard formula. The residual short equity exposure should not be considered to increase in value after application of the downward shock to equity values.

The symmetric adjustment to be applied to equities has been updated to reflect recent movements in the relevant equity index. An adjustment of -7% is now used in the technical specifications, compared to -9% under QIS5. As a result, the stresses to be applied under the equity risk sub-module for future quantitative assessments have been updated to 32% for Type 1 equities (previously defined as "Global" equities under QIS5) and 42% for Type 2 equities ("Other" equities under QIS5). The stress to be applied to strategic participations remains unchanged at 22%.

Property risk sub-module

Under the technical specifications, direct or indirect participations in real estate companies that generate periodic income, or which are otherwise intended for investment purposes, should no longer be treated as property for quantitative assessments (as under QIS5). Rather, they should be considered under the equity risk sub-module.

Spread risk sub-module

The scope of application and calculations of the spread risk sub-module that firms should use for future quantitative assessments remains broadly unchanged since QIS5. Changes have been made to the tables of risk factors that should be used by firms to calculate the spread risk capital requirements, in order to make these consistent with those set out in the DIM text. The risk factors set out in the technical specifications now vary by duration and a specific table of risk factors is included to be used for bonds issued by (re)insurance firms which do not meet their MCR.

The technical specifications also include new specific tables of rating factors, in line with Articles 159, 162 and 163 of the DIM text, to be applied to:

- Mortgage-covered bonds and public sector bonds;

- governments, central banks, multilateral development banks and international organisations;
- repackaged loan products; and
- credit derivatives.

Consistent with the requirements for QIS5, the technical specifications include a simplified calculation for spread risk for bonds and loans, other than residential mortgage loans. While the approach and risk factors to be used under this approach are consistent with QIS5, the maximum modified durations for each credit rating have been adjusted for use in future assessments.

The changes to the risk factors for the spread risk sub-module address concerns raised during QIS5 that the capital charges for bonds were excessively penal at longer durations. This risked incentivising firms to invest in shorter-dated assets in order to reduce capital requirements. Such action would potentially have been contrary to good risk management and at the same time risked reducing the stabilising effect of insurers' long-term investment horizon on markets.

While this effect, and the overall spread risk capital requirements, look likely to be reduced in future quantitative assessments through the use of duration-dependent risk factors, the capital charges for longer-dated bonds remain high. As such, for life firms in particular, we would expect this sub-module to continue to be the largest source of capital requirements under future assessments.

We note that the risk factors for repackaged loan products appear to carry through the inconsistent capital charges for BBB rated assets from DIM text into the specifications.

This was highlighted previously by Fitch Ratings which noted in its report "Solvency II and Securitisation: Significant Negative Impact on European Market" that "capital charges of securitisation assets indicate that "BBB" rated assets attract the maximum capital charge of 40% in contrast to the maximum capital charge of 76% for single "A" rated assets, both subject to duration caps". Fitch further noted that "as there is no rational explanation for this, it is Fitch's opinion that this is a typographical error that will be subject to change in the final version of the rules".

Market risk concentration sub-module

The technical specifications include new text setting out that, where exposures come via investment funds, the concentration risk sub-module should be applied, where possible, by aggregating the exposures to sub-counterparties within the investment funds at the portfolio level (rather applying it at the level of the investment fund).

There are minor changes to the list of assets which should not be included under the concentration risk sub-module:

- the value of participations in financial and credit institutions that are deducted from own funds no longer need to be included; and
- where the exposure is to a counterparty in the same group, two additional criteria are included in the list of conditions that need to be met for these exposures to be excluded from the concentration risk sub-module. These require the counterparty to be established in the European Union and to be subject to the same risk evaluation, measurement and control procedures as the firm.

The approach that firms should use for calculating the risk concentration capital under future quantitative assessments is unchanged from that set out in QIS5. However, the ability to adjust the capital charge for unrated (re)insurance counterparties subject to Solvency II based on their solvency ratio has been removed and, instead, a parameter of 73% should be used for all unrated counterparties (consistent with the DIM requirements).

Other changes to the market concentration risk sub-module include:

- mortgage covered bonds and public sectors bonds can now be rated AAA as well as AA (consistent with the DIM text);
- the text specifying that Government bonds should be included in the property concentration risk capital has been removed (consistent with the DIM text); and
- new text has been included clarifying that the zero risk charge afforded to exposures to governments, central banks, multilateral development banks and international organisations does not apply to entities owned by these organisations.

SCR – Counterparty risk module

The approach and calculations to be performed under the counterparty default risk module for quantitative assessments have changed significantly since QIS5, largely to incorporate the significant changes made in the DIM text.

In addition to these updates, there are a number of areas in which the technical specifications have been further changed relative to the DIM text, as set out below.

Default probabilities

The probabilities of default (“PDs”) specified in the technical specifications have been amended, relative to the DIM text, for certain counterparties.

For the purposes of future quantitative assessments, all unrated counterparties (apart from credit and financial institutions who comply with the EU Capital Requirements Directive) are now assigned a PD of 4.175%. This has changed from the approach set out in DIM which assigned a PD of 0.5% for unrated third country (re)insurers subject to an equivalent solvency regime, and used a table of PDs based on solvency ratio for unrated Solvency II (re)insurers who meet their MCR.

In addition, rated Solvency II (re)insurers who do not meet their MCR should now be assigned a PD based on their credit rating for future assessments, rather than automatically being assigned a PD of 4.175% (as set out in the DIM text).

Assigning a PD based on credit rating looks likely to reduce the counterparty default risk capital under future assessments for (re)insurance counterparties who do not meet their MCR but who have maintained a credit rating of BB or higher (the PD for a BB-rated counterparty being 1.20%). However, we note the extent of any reduction will depend on the speed and magnitude of the reaction of rating agencies to the financial position of the counterparty.

In contrast, the consistent application of the maximum PD to unrated counterparties may be expected to increase capital requirements for quantitative assessments, perhaps significantly. We note the largest increase would likely be in respect of unrated (re)insurance counterparties who report under Solvency II and who have strong solvency ratios. Under these changes, the PD for such a company with a solvency ratio of 150% will increase from 0.1% to 4.175%. The extent to which this change impacts firms will be commensurate to their exposure to unrated counterparties.

It is currently unclear whether the changes made to the counterparty risk module (compared to the requirements set out in DIM) are intended as simplifications for the purpose of quantitative assessments or represent the current thinking of how counterparty risk capital should be calculated under Solvency II.

Collateral

The proportion of the collateral held in respect of reinsurance, securitisation and derivative contracts that can be taken into account in the loss-given-default (“LGD”) calculations for future quantitative assessments has also been updated. In DIM, 100% of the risk-adjusted value of collateral could be used if, in the case of counterparty insolvency, calculation of the firm’s share of the counterparty’s assets does not take into account the fact that collateral is held. This provision has been removed from the updated technical specifications and the collateral values are reduced in line with the rest of the LGD calculation in all situations.

Risk-mitigating effects

Where a contract impacts both the underwriting and market risk sub-modules, the technical specifications state that the aggregate risk-mitigating effect across both sub-modules should be used for future quantitative assessments (rather than the approach under the DIM text which restricted the impact to a single sub-module).

The LGDs for contracts with risk-mitigating effects on other SCR sub-modules are increased by a proportion of the risk-mitigating effects. This update may increase the LGDs, and hence counterparty default capital requirements, calculated for future quantitative assessments in respect of those contracts that impact both the underwriting and market risk sub-modules.

The conditions under which firms can use simplifications when calculating the risk-mitigating effects of reinsurance, securitisation and derivative contracts have also been relaxed. For QIS5, these simplifications could only be used where the capital requirement for counterparty default risk was less than 20% of the overall SCR. This requirement has been removed from the technical specifications.

Mortgage loans

The criteria for treating mortgage loans as Type 2 (i.e. diversified) counterparty exposures have also been relaxed for the purposes of future quantitative assessments. In particular, the following criteria have been removed from the specifications:

- the property must be revalued at least once every 3 years, and more frequently in turbulent markets (or if the company receives information that the property's value may have declined materially relative to the general market);
- the firm must clearly document its lending policies and the types of residential property on which it will grant mortgage loans;
- the firm should have in place procedures to ensure the property is adequately insured; and
- the firm must report data on mortgage losses to the supervisory authority.

In addition to the detailed changes there are 2 minor inconsistencies in the text:

1. *The inequalities used to describe the overall capital requirement for Type 1 exposures ($SCR_{def,1}$) do not include a range for the final condition. Under the DIM text, the final condition is applied when the standard deviation of the loss distribution is greater than 20%.*
2. *The updated text describing the LGD for derivative contracts suggests that the derivative market values can be netted off with liabilities towards the counterparties to the extent that they can be set off in the case of default. However, the text makes reference to 'Recoverables' rather than 'Market Value', suggesting that this text has been copied forward from the reinsurance and securitisations LGD description without the necessary wording changes.*

SCR – Life underwriting risk module

The wording of the technical specifications in relation to the life underwriting risk module has been updated to bring it in line with the DIM text. However, these changes do not alter the scope of application or calculation that firms should apply under future quantitative assessments and, as such, the requirements for the calculation of capital in respect of life underwriting risk are unchanged from those used in QIS5.

SCR – Non-life underwriting risk module

There have been some noticeable changes with regard to the SCR calculation for the non-life underwriting risk that firms should use for future quantitative assessments. In general, many of these changes have brought the technical specifications in line with the DIM text.

Non-life premium & reserve risk sub-module

Premium and reserve risk factors have been updated since QIS5 (generally downwards, save for assistance and legal expenses risks) and remain identical to the ones published in the DIM text. We note that the lognormal approximation of 3σ has been retained for the capital charge.

The definition of the volume of premium used for premium risk has also changed since QIS5. It is now based on premium to be earned in the forthcoming 12 months plus any premium to be earned more than 12 months after the valuation date related to existing contracts and, to contracts where the initial recognition date falls in the following 12 months but excluding premiums to be earned during the 12 after the valuation date. The text clarifies the definition used in the DIM text.

The adjustment factor for non-proportional reinsurance, NP_{lob} , is now set by default to 80% for the lines of business motor vehicle liability, fire and 3rd party liability. (Re)insurance companies will still be able to use their undertaking specific NP_{lob} factor provided that they are approved by the regulator.

We note that the NP_{lob} factor was rarely used in QIS5 due to difficulties in collecting relevant information to calculate it. Despite this, the concept remains in the text and is now, by default, fixed to 80% for lines of business which would normally benefit for non-proportional reinsurance arrangements.

This parameterisation is likely to be welcomed by many firms, particularly those which did not benefit from this factor in QIS5 due to calibration difficulties.

The geographical diversification factor is set to 1 for the non-proportional lines of business (it was previously the case only for credit and suretyship). It was previously noted in QIS5 that this diversification factor should be set to 1 when USPs were used. This constraint has been removed.

Non-life lapse risk sub-module

The three shocks considered for lapse risk in the QIS5 technical specifications are now replaced by a shock of 40% which should apply to (re)insurance policies for which a discontinuance results in an increase of premium provision (mid-term cancellation) and a shock of 40% of the number of future contracts taken into account within the premium provision.

A lack of clarity in the technical specifications may lead to differences in interpretation between firms, which should be subject to materiality and proportionality considerations.

In particular, the 40% shock to be applied to policies for which discontinuance results in an increase in premium provision may be difficult to put in place in practice. Performing these calculations at the line of business level may not be sufficiently granular, as specific lines of business may contain a mixture of “profitable” policies (to which the shock would apply) and “unprofitable” policies (to which the shock would not apply). However, applying this at a per-policy level may be impractical for many firms.

Furthermore, we note the 40% shock for lapse risk could prove to be onerous for firms writing profitable business (i.e. with a combined ratio below 100%) and with a mid-term cancellation rate historically low.

Non-life CAT risk sub-module

The CAT risk module has been redefined compared to the QIS5 technical specifications. The text makes it clear that, for natural catastrophe, the risk factor method can only be applied to the countries not included within the standardised scenarios. The aggregation order has changed and is now done between the factor-based and scenario-based methods initially and then by type of CAT-risk (i.e., natural catastrophes, man-made, non-proportional and other).

We note there is still a lack of clarity in relation to the premium volumes to be used for the factor based method for the calculation of non-life CAT risk capital requirements. Basing this on an “estimate of premiums to be earned by undertakings for each contract that covers the obligations in paragraph 6 during the following 12 months”, risks duplicating the same volume of premiums for the different perils which in turn may lead to very high capital charges.

In general, the changes made to the non-life CAT risk sub-module are likely to have mixed impacts on firms, making it difficult to assess the overall impact of these changes. While some changes may be viewed as negative for firms (e.g. 100% correlation between the natural catastrophe risk and the non-proportional property risk against zero previously) others, such as the general decrease of the man-made liability factors, may improve firms' capital positions.

The overall impact of the changes to the non-life underwriting module on firms is unclear. While some of these changes may be considered as more favourable to undertakings (e.g. in most cases risk factors for premium and reserve risk are lower), whereas others are likely to be more onerous either in terms of capital requirements or in terms of calculation (e.g. lapse risk).

In general, we believe further clarification has been brought to the technical specifications which should hopefully narrow the range of possible interpretations and make the whole process more consistent across the industry.

We note that undertaking specific parameters have not been treated in this first part of technical specifications.

40% in the level of new business used in the calculation of technical provisions;

- changing the definition of volume of premium and the capital charge calculation (which now specifies the lognormal approximation of 3σ) used for premium risk for NLST Health for future quantitative assessments in line with the non-life underwriting risk module;
- substantially changing the text detailing the calculation of the capital requirements for each scenario under the health catastrophe risk module, in line the DIM text, to make the definitions more generic; and
- renaming the "arena" disaster scenario under the health catastrophe sub module to "mass accident" scenario.

In addition to the above changes which have been made to technical specifications to bring them in line with the DIM text, a number of the values assigned to risk factors have been adjusted relative to both QIS5 and the DIM text. As such, the premium risk factors for medical expenses, income protection and workers compensation factors have all been revised upwards, while the reserve risk factor for medical expenses has been reduced from 10% (in both QIS5 and DIM) to 5%. All the other NSLT health reserve risk factors remain unchanged.

SCR – Health underwriting risk module

The technical specifications in relation to the health underwriting risk module have also been updated to bring these in line with the DIM text. As such, there are a number of adjustments to the requirements for the calculation of capital for health underwriting risk used in QIS5, including:

- the inclusion of simplified approaches for the calculation of capital for quantitative assessments for SLT health mortality, longevity, disability/morbidity and expense risk, consistent with the corresponding life sub-modules;
- updating the calculation of capital requirements for SLT and NSLT health lapse risk to be based on the combination of instantaneous lapses of 40% of insurance policies for which discontinuance would result in a positive increase in technical provisions without the risk margin and, where reinsurance contracts cover future business, an instantaneous decrease of

We note that there appears to be some confusion in the text in relation to the calculation of capital for medical expense products under the pandemic risk scenario in the technical specifications.

In line with QIS5, the technical specifications acknowledge that the pandemic risk for medical expenses will be small and hence is not specifically covered under pandemic risk, as it is considered to be captured in the premium and reserve risk module. Despite this, the technical specifications have been updated, in line with the DIM text, to include a calculation of the amounts payable under a medical expense policy in a pandemic scenario. This includes assumptions about the proportion of people expected to be hospitalised, and the proportion of people expected to consult a medical practitioner and thus incur insured medical expenses.

It appears likely that the original text from QIS5, excluding medical expenses from pandemic risk, should have been deleted from the technical specifications. As such, we believe firms will need to calculate this component for quantitative assessments.

While the capital in respect of this component is likely to be insignificant, it appears likely that this will vary significantly between companies, due to different covers, and between countries, depending on the level of national health provision.

SCR – Ring-fenced funds

The section in relation to the treatment of ring-fenced funds (RFFs) has been significantly re-written for the purposes of future quantitative assessments. This includes details on identification of RFFs, circumstances under which an adjustment should be made to own funds due to the existence of a RFF (and the corresponding impact on the calculation of the SCR), and the approach to be taken for making these adjustments.

The updated text sets out 5 steps that firms should follow in order to determine whether an adjustment to own funds is required in respect of RFFs:

1. **Identify any RFFs** – by assessing whether any own funds items have a reduced capacity to fully absorb losses on a going concern basis due to lack of transferability within the firm. Specific examples of RFF include:
 - with-profits arrangements;
 - legally binding arrangements or trusts created for the benefit of policyholders;
 - provisions in the articles of association or statutes of the firm;
 - national regulation; and
 - EU law, including Solvency II (e.g., in relation to the use of a matching adjustment if required).
2. **Identify all assets and liabilities in the RFF**
3. **Calculate the notional SCR for the RFF** – by applying either the standard formula or an internal model to the RFF as if it were a separate undertaking. Where the RFF includes profit participation arrangements, the change in basic own funds under the scenario-based calculations should consider changes in technical provisions due to expected changes in future discretionary benefits.
4. **Adjust the reconciliation reserve for restricted own funds in the RFF** – by excluding the amount of restricted own fund items in excess of the notional SCR for that RFF from the amount of own fund items available to cover capital requirements.
5. **Calculate the SCR for the whole firm** – determined as the sum of the notional SCRs for each RFF and the notional SCR for the rest of the firm. Any negative notional SCRs should be set to zero and no diversification is permitted between RFFs and/or between RFFs and the rest of the firm.

An example of how the adjustment should be calculated is provided in Annex V of the technical specifications.

Where the effect of an RFF is determined not to be material, firms may exclude the total restricted own fund items from the total eligible own funds used to meet capital requirements under future quantitative assessments. Criteria for assessing materiality of the effect of an RFF are set out in the technical specifications, although it should be noted that any RFF maintained through the operation of EU law is always regarded as material.

While the text in relation to the identification of ring-fenced funds makes mention to possible ring-fencing requirements around the application of the matching adjustment, this is dependent on whether such a requirement is defined within EU law, in this case in the form of the finalised Level 1 text.

We note that recent proposals considered during the trilogue discussions on Omnibus II, would require that assets and liabilities subject to the matching adjustment are ring-fenced or identified, managed and organised separately from the other activities of the insurance undertaking. If these proposals were to be adopted, application of the matching adjustment would not automatically correspond to the establishment of an RFF.

While trilogue discussions are on-going in this area, we would expect further clarity on the current thinking to be reflected in part 2 of the updated technical specifications. However, as EIOPA caveats, this would only be for the purposes of future quantitative assessments and would not necessarily reflect the final position of Solvency II.

SCR – Financial Risk Mitigation

The treatment of financial risk mitigation techniques under the future quantitative assessments is broadly consistent with that set out for QIS5. However, the requirement that all material risks arising from the use of the financial risk mitigation techniques should be reflected in the SCR, regardless of whether that technique is considered admissible, has been removed from the latest text (and a consistent change made in respect of insurance risk mitigation techniques).

Basis risk

Consistent with QIS5, where the financial risk mitigation technique introduces material basis risk (relative to the mitigation effect), as a result of differences between the underlying assets exposures of the mitigation instrument and the exposures of the firm, the mitigation technique cannot be used in the calculation of the SCR. To be used in future quantitative assessments, the technical specifications require the change in value of the exposures of financial risk mitigation techniques to mirror the change in value of the

firm's exposures by at least 90% based on an assessment which should consider at least:

- the behaviour of both exposures under the relevant module or sub-module of the SCR;
- the degree of symmetry among both exposures;
- any non-linear dependencies under the relevant SCR scenario;
- any relevant asymmetry of the behaviours in case of bi-directional SCR scenarios;
- the levels of diversification of each respective exposure;
- any relevant risks not captured explicitly in the standard formula; and
- the whole payout distribution applying to the risk-mitigation technique.

Furthermore, the technical specifications include new text stating that material basis risk would exist where the financial risk mitigation technique is not listed in regulated markets in EEA or OECD member states, and is not cleared by a central counterparty clearing house.

Rolling and dynamic hedging

Where firms are using rolling hedging arrangements, the technical specifications include two new conditions that must be met in order for the hedge programme to be permitted as a risk mitigation technique under future quantitative assessments:

- firms are required to reduce the level of protection of the hedge in the SCR to reflect the risk of replacement costs for the hedge increasing; and
- the replacement of the hedge must not be conditional on any future event which is out of the control of the firm (if the future event is under the control of the firm this should be clearly documented in the written policy for the replacement of the risk-mitigation technique).

As under QIS5, dynamic hedging should not be treated as a risk mitigation technique.

Credit derivatives

Where credit derivatives are used to mitigate credit exposures, the procedures and criteria for incorporating these within the SCR calculation are consistent with those set out in QIS5. However, where restructuring of the underlying obligation is not recognised as a credit event under the derivative, the ability to recognise partially the

protection offered, as allowed under QIS5, has been removed.

Collateral

Where collateral is pledged or transferred to reduce the exposure to default events, the technical specifications include new criteria, in line with the DIM text, requiring firms to determine that the collateral is:

- of sufficient credit quality and liquidity and is sufficiently stable in value; and
- guaranteed by a counterparty who has been assigned a risk factor for spread risk of 0%.

Furthermore, the text now states that “*there should be no material positive correlation between the credit quality of the counterparty and the value of the collateral*”.

SCR – Insurance Risk Mitigation

Where firms are using reinsurance as an insurance mitigation technique, the technical specifications have been updated in line with the DIM text to require the counterparty to be an insurance or reinsurance firm which:

- complies with the SCR (if under Solvency II)
- complies with local solvency requirements (if situated in an equivalent regime under Article 172 of the Solvency II Directive); or
- has a credit rating of A or better (if situated in a third country with a non-equivalent regime).

Consistent with the requirements surrounding financial risk mitigation, in order to include the impact of insurance risk mitigation in the calculation of the SCR for future quantitative assessments, firms are required to demonstrate that any basis risk is not material compared to the mitigation effect.

Whereas the QIS5 technical specifications provided specific details on the assessment of basis risk under the non-life premium and reserve risk module of the SCR, the current text requires firms to consider whether the reinsurance or SPV arrangements have differences, either in “terms or in conditions”, compared to the actual insurance policies written by the firm and, if differences exist, whether these have, or may have, an actual or potential material impact on the outcome of the risks of the firm.

SCR – Simplifications applicable on ceding undertakings to captive reinsurers

The scope of the section of the technical specifications in relation to captives has been significantly reduced from QIS5. All text relating to simplifications that were only applicable to captives with a specific business model has been removed.

The remaining text relating to simplifications applicable to ceding undertakings to captive reinsurers is unchanged from QIS5.

SCR – Solo treatment of participations

The section of the technical specifications setting out the treatment of participations in each area for future quantitative assessments has been significantly re-written since QIS5 to add more clarity to the guidance. This sets out details of how participations should be identified and valued together with the treatment of participations in the SCR standard formula and calculation of Own Funds for quantitative assessments.

Identification of participations

While the definition of participations is unchanged from QIS5, new criteria are set out in the technical specifications for identifying participations by virtue of the exertion of dominant or significant influence and for splitting participations into participations in “financial and credit institutions” and “strategic participations”.

For the purposes of future assessments, identification of participations by virtue of the exertion of dominant or significant influence should be based upon where the firm can exert a dominant or significant influence over another company and should consider:

- current shareholdings and potential increases in this due to the holding of options, warrants or similar instruments;
- representation on the Board;
- involvement in decision-making processes (including decisions about dividends or other distributions);
- material transactions between the firm and the potential related undertaking;
- interchange of managerial personnel;
- provision of essential technical information; and
- sufficiently large mutual membership.

New guidance in the technical specifications identifies equity investments that should be considered as strategic participations for the purposes of future quantitative assessments. These are defined as those where the value of the equity investment is likely to be materially less volatile than the value of other equities over the following 12 months (due to both the nature of the investment and the influence of the firm in the related undertaking), and where the investment is strategic. In assessing whether a holding is “strategic”, firms should consider:

- the existence of a clear decisive strategy to continue to hold the participation for a long period;
- the consistency of the strategy with the main policies guiding or limiting the firm;
- the ability of the firm to continue holding the participation;
- the existence of a durable link; and
- consistency of the strategy with the main policies guiding or limiting the group (where appropriate).

Valuation of participations

The valuation of participations for future quantitative assessments is unchanged from the approach used under QIS5.

Treatment of participations in the SCR standard formula

The technical specifications include revised text on the treatment of participations in the SCR standard formula. This sets out the following treatment for the equity and subordinated liability components of participations in future quantitative assessments:

- the interest rate and spread risk sub-modules relevant to bonds should be applied to subordinated liabilities;
- the relevant equity risk charges should be applied to equity holdings;
- preference shares should be treated as Type 2 equities (and hence stressed subject to a 42% immediate fall in value); and
- any additional market risk sub-modules (such as currency) should be applied as appropriate.

Treatment of participations in the calculation of Own Funds

The treatment of participations in own funds for future quantitative assessments has been updated to reflect the DIM text. Under this, where individual participations in financial and credit institutions exceed 10% of the total own funds, the full value of the participation must be removed from basic own funds (if necessary, the remaining participations must be reduced on a pro-rata basis such that they only make up a maximum of 10% of total own funds in aggregate).

SUMMARY

The updated technical specifications published by EIOPA set out the approach that should be used by firms when performing calculations for future quantitative assessments of the Solvency II requirements. These make a number of changes to the previous specifications used by firms during the QIS5 exercise.

A second part of the technical specifications is due to be released in due course and is expected to provide further details relating to the valuation of liabilities, and in particular the discount rate to be used.

There have been a number of changes to the specifications relating to the calculation of the SCR. While the majority of these have been made to update the technical specifications in line with the DIM text produced in October 2011, additional guidance is included in a number of areas to add clarity to how firms should treat specific items under future assessments.

Significant changes have been made to the counterparty risk module. While many of these bring the technical specifications in line with DIM, a number of further changes have been made to the requirements. It is unclear whether these changes are ad hoc simplifications, made for the purposes of quantitative assessments, or represent the current thinking of how counterparty risk capital should be calculated under Solvency II.

As EIOPA has highlighted, these technical specifications make use of ad hoc simplifications for the purposes of impact assessments and, as such, should not be considered as a complete implementation of the Solvency II framework.

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