

2020 Review of Solvency II - Other issues

Issue	Further description
<p>Calibration of the standard formula lapse risk parameters.</p>	<p>There are several well-known issues relating to the design and calibration of standard formula lapse risk shocks. These are summarised below:</p> <ul style="list-style-type: none"> ■ Calibration of the non-life lapse risk sub-module (Article 118) ■ Calibration of the life lapse risk sub-module (Article 142) ■ Assessment of the risk at individual policy-level which results in an exaggeration of the impact of a lapse event. <p>In its 2009 advice, CEIOPS proposed a mass lapse calibration of 30% for retail business and 70% for non-retail business. (CEIOPS' CP49 on the Mass Lapse from October 2009). These calibrations were used in the QIS 5 exercise but were subsequently increased to 40% for retail business prior to the implementation of Solvency II.</p> <p>Insurance Europe has previously highlighted that the calibration of these factors is unduly onerous and does not reflect insurers' experience. In the annex to this document, we have provided data from three markets which supports this contention. A copy of our response to CEIOPS's advice in 2009 has also been provided which includes a more detailed assessment of historical company events.</p> <p>It is also worthwhile highlighting that the proposal to grant NSAs with the power to impose a temporarily freeze on redemption rights in exceptional circumstances would also justify a recalibration of the mass lapse parameters.</p> <p>As well as supporting a recalibration, Insurance Europe has advocated for the extension of the USP framework to lapse risk, as was foreseen in the Solvency II directive. In our response to the consultation on the 2018 review, we provided a concrete proposal to extend USPs to cover lapse risk which was rejected by EIOPA.</p> <p>Insurance Europe supports both a recalibration of the lapse risk parameters as well as the extension of the USP framework to cover lapse risk and kindly requests the Commission to investigate these issues as part of the 2020 Review of Solvency II.</p>

<p>Transition to the new risk-free rate in the euro area, from IBOR to ESTER</p>	<p>The reform of the IBOR risk-free rates may have an impact the SII RFR curve for a number of different currencies.</p> <p>Changes to the credit risk adjustment and the swaps which are used as the basis for RFR curves may be needed. The forthcoming changes to the IBORs should be considered as part of the 2020 Review to ensure that any changes to Solvency II are consistent with the expected changes to the IBOR rates.</p>
<p>Article 275 – treatment of insurance claims</p>	<p>Netting arrangements should be excluded from the absolute precedence of insurance claims (Art. 275 (1) (a))</p>
<p>Profit and loss attribution in internal models: Proposal to simplify Art. 123 SII-Directive and Art. 240 DRA</p>	<p>The annual review of the causes and sources of profits and losses for each major business unit within an internal model constitutes a disproportionate burden in relation to the limited gain of knowledge for the undertakings as well as for the supervisory authorities.</p> <p>Therefore, we propose to revise this requirement. A triennial attribution would represent a more proportionate exercise.</p>
<p>Art 188 of Delegated Regulation Property priced in EUR; currency risk</p>	<p>According to Art. 188 of the Delegated Regulation (EU) 2015/35, immovable property is sensitive to the currency of the country in which it is located. This means properties located in Poland are sensitive to PLN in Solvency II. However, most commercial properties in Poland are priced in EUR (economically, under IFRS). To avoid the currency risk, undertakings hedge the position using the FX Swaps.</p> <p>From business perspective, the undertaking has neutral currency position but under Solvency II the undertaking has negative currency position (from FX transactions) and in consequence significant currency risk.</p> <p>The requirement that immovable property is considered to be sensitive to the currency of the country in which it is located should be removed.</p>
<p>Interpretation of Art. 18 (1) lit. a) SII</p>	<p>The present wording of Art. 18 (1) lit. a) SII is unclear. Different interpretations of this Article create inconsistencies in the treatment of insurers and their customers across Europe.</p> <p>It should be clarified that Article 18 does not restrict any insurers making investments in a subsidiary which facilitates the provision of ancillary services, such as residential care, to their policyholders.</p>
<p>Definition of “reinsurance” (Art. 13 (7) S II- Directive which restricts the direct purchasing of reinsurance to those entities in scope of SII)</p>	<p>Currently, reinsurance is defined as the risk transfer (exclusively) between (authorized) insurance undertakings that fall under Solvency II. Consequently, public health insurers, small insurers, certain mutual insurers and certain pension funds can only buy reinsurance protection via the detour of a primary insurer which entails increased costs and counterparty risk.</p> <p>This situation results from Article 13 (7) in conjunction with Article 14 and Articles 2ff:</p> <ul style="list-style-type: none"> • Article 13 (7) defines 'reinsurance' as the transfer of risk from either insurance or third-country insurance to other

	<p>insurance undertakings, or the assumption of risk under a Lloyds consortium.</p> <ul style="list-style-type: none"> • Article 14 restricts the concept of an insurance undertaking to undertakings authorized by the supervisory authorities and included in the scope of application of the Solvency II Directive. • Articles 2ff limit the scope of the Solvency II Directive. This exempts certain companies that either engage in direct insurance or insurance-type business from the application of the Solvency II Directive. <p>This restriction should be removed by amending Art 13(7).</p>
<p>Finite Reinsurance: Proposal to delete Art 210 S II-Directive and amendment of Art. 208 (2) DRA</p>	<p>A contract is only defined as a reinsurance contract if it allows for an effective risk transfer, otherwise it is not a reinsurance contract. Only reinsurance contracts can be accounted for the volume of premium and reserve risk as well as undertaking specific parameters (USP). Therefore, the additional definition of finite reinsurance in Art 210 is obsolete.</p> <p>Additionally, Art. 210 exists for historical reasons only. In former days, the introduction of the concept of financial reinsurance as a special category of reinsurance, which on the one hand forces insurers to take special measures in risk management and the controlling of corresponding contracts and, on the other hand, entails special additional reporting requirements to supervisors, was the result of problems arising from some specific reinsurance constructions:</p> <ul style="list-style-type: none"> • Non-Life Reinsurance with limited liability • Transfer of claim reserves in connection with interest obligations • Reinsurance contracts with loan character <p>Under Solvency II such constructions are no longer possible:</p> <ul style="list-style-type: none"> • With respect to limited-liability contracts, recognition of solvency capital relief is no longer possible due to the clauses of Articles 209 to 212 of the Delegated Acts. The said articles require detailed proof of effective transfer of risk under a reinsurance contract. • There is no need for contracts, under which interest obligations are transferred, since all reserves under Solvency II are to be discounted in any case. Furthermore, the concept of "Reinsurance Recoverables" requires an economically correct valuation of all payments under a reinsurance contract, taking full account of any interest payments. • The improvement of solvency ratios through reinsurance financing is not possible under Solvency II, as all payments to the reinsurer are to be recognized on the basis of the "best estimate" in the solvency balance sheet. In addition, contracts with unconditional repayment obligations must also be accounted for and recognized as loans in accordance with commercial law. <p>The deletion of Article 210 SII-Directive and of Article 208 (2) DRA would be appropriate.</p> <p>Alternatively, the definition of 'financial reinsurance' in Article 210 (3) could be adjusted as follows:</p>

	<p><i>For the purposes of paragraphs 1 and 2 finite reinsurance means reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, exceeds the premium over the lifetime of the contract by a limited but significant amount, and there exist contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer.</i></p> <p>Article 208 could be amended to the following (para. 2 should be deleted): <i>Methods and Assumptions</i></p> <p><i>1. Where insurance or reinsurance undertakings transfer underwriting risks using reinsurance contracts or special purpose vehicles that meet the requirements set out in Articles 209, 211 and 213, and where these arrangement provide for protection in several of the scenario-based calculations set out in Title I, Chapter V, Sections 2, 3 and 4, the risk-mitigating effects of these contractual arrangements shall be allocated to the scenario-based calculations in a manner that, without double-counting, captures the economic effect of the protections provided. In particular, the economic effect of the protections provided shall be captured in determining the loss in basic own funds in the scenario-based calculations.</i></p>
<p>Access to third country reinsurance</p>	<p>Articles 162–171 of Directive 2009/138/EG do not address the market access of third country undertakings providing reinsurance. This leads to a fragmented and inconsistent regulatory landscape, as some Member States impose a local presence requirement on such undertakings while others don't. As a result, insurance and reinsurance undertakings are confronted with an unlevel playing field if they consider ceding (re-)insurance risks to undertakings located outside the European Union on a cross-border basis.</p> <p>Therefore, the market access of third country (re)insurers providing reinsurance should be harmonised in accordance with international standards. Insurance Core Principle 13.4 of the International Association of Insurance Supervisors (IAIS) emphasizes the cross-border nature of reinsurance transactions and the market sophistication of the parties involved. This should be translated into a regulation which requires Member States to grant market access if the third country (re-)insurer is authorized to conduct reinsurance business in its jurisdiction and national competent authorities deem the supervision performed by and the cooperation with their third country counterparts as adequate. Such an approach would also be in line with the equivalence concept for third country reinsurers pursued by Article 172 of Directive 2009/138/EG as it applies to the treatment of reinsurance contracts for solvency purposes only. However, Article 172 of Directive 2009/138/EG should be adapted to Articles 227 and 260 of Directive 2009/138/EG. These provide not only for an "equivalence decision" but also for the possibility of an "equivalence assessment" by the national supervisory authorities, which results in both being equal.</p>
<p>Article 174 should be amended to ensure market access for third-country reinsurers without authorization.</p>	<p>Directive 2009/138/EG does not stipulate an authorization requirement for reinsurance business conducted by third-country insurers or reinsurers. The absence of regulation leads to a fragmented landscape in Member States in terms of granting market access for cross-border reinsurance offered from licensed insurers or reinsurers outside the community. While the majority of Member States do not establish any regulatory obstacles for cross-border reinsurance from third countries, other Member States impose local presence requirements on these (re-) insurers except undertakings with their head office in the USA. The EU-US Bilateral Agreement prohibits Member States to maintain national requirements which would contradict the Agreement. Consequently, the inconsistent regulation in Member States creates an unlevel playing field for insurers seeking reinsurance cover and reinsurers seeking retrocession cover from outside the EU. In particular, the business model of European reinsurers relies on</p>



the global diversification of risks. The essential capacity to retrocede reinsurance risks to third-country (re-) insurers is considerably limited in Member States, which impose local presence requirements. Notwithstanding competitive implications, the situation undermines the ambition to ensure convergent supervisory approaches. It is also detrimental for the reputation of the European Union as a business location.

Article 174 should be amended in order to: (i) ensure consistent regulation on third-country (re-) insurers conducting reinsurance business within the EU; (ii) preserve the principle that third-country (re-) insurers should not be required to apply for authorization; and (iii) be aligned with international supervisory standards with regard to the supervision of cross-border reinsurance as set out in Insurance Core Principle 13.4. At the same time, Member States have the opportunity to make market access contingent on their assessment about the depth of supervision exercised in third-countries and the cooperation between the supervisory authorities involved.

Dutch market (analysis provided by VVN)

Article 118, Non-life lapse risk sub-module

We conclude that the 40% of article 118 of the Delegated Regulation is too high. Unfortunately, we were not able to differentiate between lapses, surrenders and expected expirations. Including all these causes for reducing the insured portfolio we calculated that in 99,5% of all cases a percentage of 34% is sufficient. Taking in account that the expected expirations should be excluded, this percentage should be must lower and is expected to be nearer 30% than 40%.

Assumed that the average duration of a car insurance is 5 years, 20% of a motor car portfolio is expiring. Because regular expirations should be deducted from the total of lapses, the overall lapse percentage for the Dutch non-life market should be substantially lower.

The percentages are determined based on data of 246 observations with multiple lines of business over eleven consecutive years. The figures do not include health insurance, but they do include income insurance.

Percentile	Lapse / Surrender / Expirations
99,5%	34%
97,5%	29%
95,0%	26%
90,0%	24%

Article 142, Lapse risk sub-module of the Life underwriting risk module

For life we conclude that 16.1% is a more realistic percentage than 40%. This percentage is determined based on data of 146 observations with individual life policies over seven consecutive years. In 99.5% of all situations the lapse rates are 16.1% or lower.

Percentile	Lapse
99,5%	16%
97,5%	14%
95,0%	12%
90,0%	11%

These figures contain traditional and unit linked policies. The figures don't include group life and group pension. Reinsured pension schemes are also not included.



Greek market (analysis provided by Hellenic Association of Insurance Companies)

The Hellenic Association of Insurance Companies (HAIC) recently launched a survey across the local market to collect and examine relative data to **demonstrate that the existing treatment of life lapse risk, as set by the Standard formula, is unnecessarily high, penalizing the companies which offer especially annuity options.**

Summary

Based on data representing over **98%** of the Greek market, the shock associated with the exercise of the annuity option, in the context of the capital requirements for lapse risk of life policies, is deemed to be too high. Pursuant to the local market's statistical data **a percentage of additional 10 pp shock, instead of 20 pp would be more appropriate.**

Key Issues of current situation

Due to its high contribution to company's Solvency Capital Requirement (SCR), most of the insurers operating in Greece have seized offering the annuity settlement option in their products, especially the guaranteed option, to the detriment of the Greek consumers who are seeking today for alternative annuities sources after the retreat of the social security system in Greece and the prolonged debt crisis the country suffered.

It is estimated that the enforcement of the shock reduced one-off by 8 pp the average Solvency ratio of the market. However, the most severe impact is that it has permanently reduced the most critical investor KPI for insurance sector, the Return on Required Capital (RoRC) by at least 0,7 pp. This constitutes a key disadvantage to the attractiveness of the insurance sector towards investors.

Addressing the issue is, also, of utmost importance for the insurance sector's future prospects, taking into account PEPP regulation along with developments regarding the increasing role of insurance undertakings in the Greek pension field.

As a conclusion, the treatment of the lapse risk needs to be reassessed because it is too penalizing and the related capital requirements are so high directing the market towards other types of products, while customers are deprived of product flexibility and options that fit their needs.

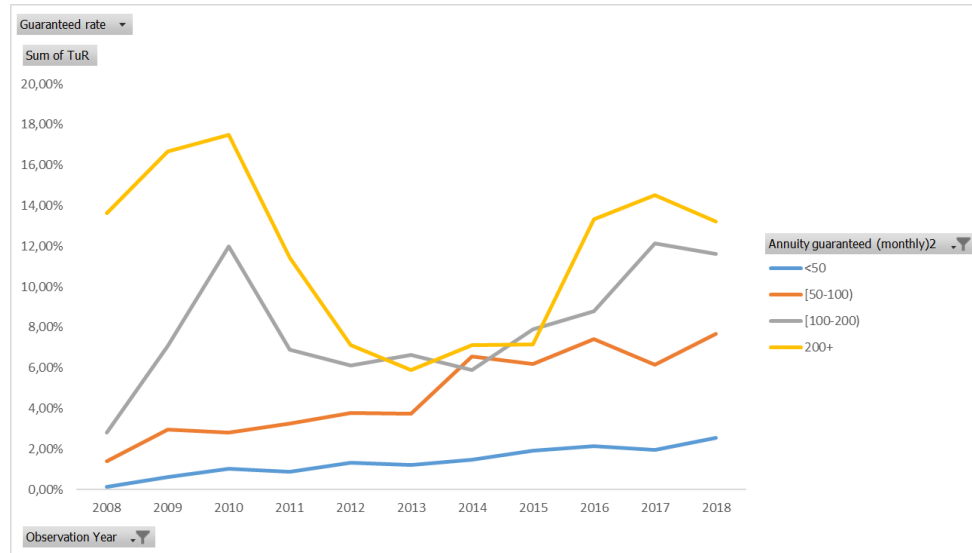
Process Description

The HAIC collected data from the market almost as a whole (98,3%) regarding the contracts with guaranteed annuity options at maturity from 1992 until 2018. The data were consolidated and measured by both the count of cases selecting annuity and their face amount. Several conclusions were driven by the statistical analysis of the data in relation to the nature of the business as well as the policyholder behavior. Overall nearly 160.000 cases in the last 10 years were collected and accumulated.

Basic Statistical Analysis



The observations were separated by face amount (monthly annuity) buckets as well as by guaranteed technical interest rates. A concrete trend is captured on the level of the monthly annuity as the higher the amount the higher the probability of annuity option selection as it makes economic sense for the policyholder. In addition to that, there is an obvious upward trend on the rates in recent years. This differentiation in the policyholder's behavior in relation to the amount of the monthly annuity that they are eligible to, is not taken into consideration in the calibration of the shock that determines the same upward trend in the take up rate. Similarly, the increasing trend that is becoming more apparent in recent years as policyholders are no longer under liquidity pressure as they were during the crisis period and their expectation from the social security system are getting lower, is a parameter ignored as well.



Take up Rate Shock and Considerations

The shock applied to the take up rate is predicted in Article 142 "Lapse Risk Submodule" and specifically paragraph 3 reads:

"3. The capital requirement for the risk of a permanent decrease in lapse rates shall be equal to the loss in basic own funds of insurance and reinsurance undertakings that would result from an instantaneous permanent decrease of 50 % in the option exercise rates of the relevant options set out in paragraph 4 and 5. Nevertheless, the decrease in option exercise rates shall not exceed 20 percentage points and the decrease in option exercise rates shall only apply to those relevant options for which the exercise of the option would result in a decrease of technical provisions without the risk margin."

In accordance with paragraph 4 that reads the following:

"4. The relevant options for the purposes of paragraphs 2 and 3 shall be the following: (a) all legal or contractual policyholder rights to fully or partly terminate, surrender, decrease, restrict or suspend insurance cover or permit the insurance policy to lapse; (b) all legal or contractual policyholder rights to fully or partially establish, renew, increase, extend or resume the insurance or reinsurance cover. For the purposes of point (b), the change in the option exercise rate referred to in paragraphs 2 and 3 shall be applied to the rate reflecting that the relevant option is not exercised."

The resulting treatment of the shock in this fashion is that the shock is applied on the same time on the lapse risk and the take up rates without any correlation between the two events and additionally to that what is even more penalizing it is applying 20 pp on the probability of the take up rates. The application of the 20 pp is totally unreasonable as the relating standard deviation of the take up rates observations do not possibly tally with that as being the 1/200 extreme event. The 20 pp is even greater than the average plus three standard deviations that is already a very extreme event under any possible distribution fit.

**Historical Annuity Conversion Option (per monthly annuity level)
Based on count of cases**

Year	Monthly annuity level				Total
	< 50	[50-100)	[100-200)	200+	
2009	0,64%	2,95%	7,07%	16,67%	1,24%
2010	1,02%	2,83%	11,98%	17,50%	1,67%
2011	0,90%	3,24%	6,90%	11,45%	1,51%
2012	1,33%	3,77%	6,13%	7,11%	1,98%
2013	1,22%	3,76%	6,64%	5,91%	2,07%
2014	1,49%	6,57%	5,92%	7,13%	2,80%
2015	1,92%	6,20%	7,89%	7,14%	3,23%
2016	2,14%	7,43%	8,79%	13,32%	3,71%
2017	1,97%	6,15%	12,12%	14,50%	3,71%
2018	2,57%	7,68%	11,63%	13,22%	4,43%
Average of period (Aver):	1,52%	5,06%	8,51%	11,40%	2,64%
St. Deviation (St. Dev):	0,61%	1,93%	2,49%	4,30%	1,10%
Average of period + 3 St. Dev:	3,36%	10,84%	15,98%	24,30%	5,92%
Average of period + 20 pps:	21,52%	25,06%	28,51%	31,40%	22,64%

The credibility and the range of the observations allow the market participants to claim that the 20pp shock applied by the standard formula for the probability of annuity take up rate within the next year is far more extreme than the 1/200 event and not justifiable by the market data for Greece.

Based on the analysis above which in total ranges at 2,64% average and 1,10% ST DEV, a percentage of 10 pp shock instead of 20 pp would be prudent enough and more appropriate.

German market (data provided by German Association of private health insurers)

The statistical data of the Association of private health insurer (DE) shows that the current mass lapse calibration with a risk factor of 40% in Article 159 DA is incorrectly calibrated. Taking into account our empirical data of good quality between the years 1995-2018 and the Solvency II calibration guidelines, a risk factor of no more than 25% at maximum should be applied.

On the 99.5%-quantile of PKV data (1995-2018) a 200 year event has been calculated with 10.02% for PKV Health.