EUROPEAN INSURANCE
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Roundtable on the SCR review

Frankfurt, 27 September 2017

Introduction

Policy options for subsequent finalisation

- Second roundtable on the review of the Delegated Regulation

- Purpose is the same as for the first roundtable:
  - Get stakeholders' first reactions to reflect on them during the drafting
  - Help them prepare for the 8 weeks consultation (November-December)

- Policy options presented are not EIOPA's final views. These are considerations EIOPA's and NCAs' staff are having at a precise point in time (cf. sticker top right corner)

Timetable

Policy options for subsequent finalisation

- First set of advice:
  - Public consultation ended beginning of September
  - We are in the process of analysing the comments and making changes to the advice where necessary
  - This first set of advice will be sent to COM by end October 2017

- Second set of advice:
  - Public consultation of 8 weeks during November-December
  - Finalisation in January 2018 and sending the final advice to COM by February 2018

- Information request to undertakings for impact assessment:
  - On LAC DT and interest rate risk
  - 8 weeks in November-December

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Policy options for subsequent finalisation

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Loss-absorbing Capacity of Deferred Taxes (LAC DT)

Elements of advice on LAC DT

Policy options for subsequent finalisation

1. Basis for advice on LAC DT
2. Role of compliance with MCR and SCR
3. Limit on profitability of new business
4. Horizon of new business
5. Returns on assets and liabilities
6. Future Management Actions (FMA)
7. Impact assessment – information request

Basis for advice on LAC DT

Policy options for subsequent finalisation

- Address three main concerns:
  - **Uncertainty** about future profits for utilization of notional DTA
  - **Complexity** involved in projections of these future profits
  - **Unlevel playing field** because of wide range of judgement involved in notional DTA
    - similarly solvent and risky undertakings have significantly different LAC DT and SCR just because of assumption settings
    - differences in tax regimes do justify differences in LAC DT; advice is not about off-setting differences in tax regimes

Role of compliance with MCR and SCR

Policy options for subsequent finalisation

- Compliance with MCR and SCR after shock loss plays a role in the amount of probable future profits for the utilization of notional DTA
  - The worse the financial situation after shock the less probable future profits become
  - No explicit requirement to meet MCR and SCR after shock
    - however, lower solvency after shock implies less future profits, i.e. more prudent assumptions; and/or
    - possibly no future profits when below MCR after the shock and 'in full' when above SCR after the shock

Limit on profitability of new business

Policy options for subsequent finalisation

- Limit assumed profitability of new business
  - Unlevel playing field; similarly risky and solvent undertakings would have different LAC DT and SCR just because of different assumption settings
  - No more profits from new business than realized in past few years
  - Possibly no future profits when below MCR after the shock but 'in full' when above SCR after the shock, see previous slide

Horizon of new business

Policy options for subsequent finalisation

- Limit horizon of new business to horizon of business plan of the undertaking
  - Unlevel playing field; similarly risky and solvent undertakings would have different LAC DT and SCR just because of different planning horizons
  - Undertakings may be inclined to lengthen horizon of business plans just for the purpose of higher LAC DT and lower SCR
- Limit horizon of new business irrespective of horizon of business plan of the undertaking is a possibility

Returns on assets and liabilities

Policy options for subsequent finalisation

- Returns on assets and liabilities equal forward risk-free interest rates
  - Consistent with the valuation of Technical Provisions, see Guideline 9 on recognition and valuation of deferred taxes
  - Implies no pull-to-par and/or equity market recovery

- Forward rates derived from post-shock term structure
  - Consistent with post-shock calculation of LAC DT
  - Risk identified: some undertakings may be inclined to adjust interest rate hedging to become exposed to upward shock, just for a higher LAC DT and lower SCR

Future Management Actions (FMA)

Policy options for subsequent finalisation

- FMA allowed if they meet all the requirements of Article 23 of Delegated Regulation
  - Similar to allowance of FMA for basic SCR calculations
- FMA allowed if execution is independent of externalities, for example:
  - Stop sale of unprofitable new business
  - Derisking

Impact assessment – information request

Policy options for subsequent finalisation

- EIOPA will send an information request for an impact assessment of its advices; data requested on
  - profitability of new business over past years
  - assumed profitability of new business in projected years in calculation of LAC DT
  - assumed profits from returns on assets and liabilities in projected years in LAC DT calculation

Risk margin – Cost-of-Capital rate

Risk margin – CoC rate

Policy options for subsequent finalisation

Call for advice of the European Commission

"Assess if the methods and assumptions applied in the calculation of the risk margin continue to be appropriate, in view of a changed market environment. In particular, EIOPA is asked to review the cost-of-capital rate."

As discussed during the last Round Table meeting on 27 March 2017 EIOPA will first focus on the review of the CoC rate.

Risk margin – CoC rate

Policy options for subsequent finalisation

Objectives for deriving the CoC rate

- Reflects economic reality
- Captures all relevant costs (e.g. dividends and share buy-backs)
- Underlying assumptions are realistic and reliable
- 'Through the cycle calibration'
- Results should not be too volatile
- Transparent
- Replicable in the future
- Simplicity

Derivation of the CoC rate

Policy options for subsequent finalisation

The derivation is still work in progress. The following elements may be considered stable:

- CoC rate is based on CoC for equity
- Three step approach based on CAPM:
  - Derivation of equity risk premium
  - Adjustment with insurance-specific beta
  - Further adjustment to take account of economic characteristics not captured by CAPM
- Equity risk premium:
  - Historical return model
  - Dividend discount model (based on Damodaran model)
- Beta: Derivation approach of initial CoC calculation should be kept.
- Further adjustment: Reduction by 20%
  - To allow for economic aspects that are not taken into account in calculation of Equity risk premium and Beta

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Recalibration of standard parameters of premium and reserve risks

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Policy options for subsequent finalisation

- Introduction
- Data
- General approach for assessing sigma
- Preliminary results

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Policy options for subsequent finalisation

Introduction

Policy options for subsequent finalisation

- Call for Advice
  - *As part of the SCR review EIOPA is asked to assess which of standard parameters for non-life premium and reserve risk, and the standard parameters for medical expense risk need to be changed and to suggest possible new calibrations where appropriate, making use of the experience gained.*
- Line of Business targeted after analysis of evidence:
  - medical expense (LoB n° 1)
  - credit and suretyship (LoB n° 9)
  - assistance (LoB n° 11)
  - legal expenses (LoB n° 10)
  - worker compensation (LoB n° 3)
- General approach: reproduce what was done for the first calibration by the Joint Working Group (JWG)

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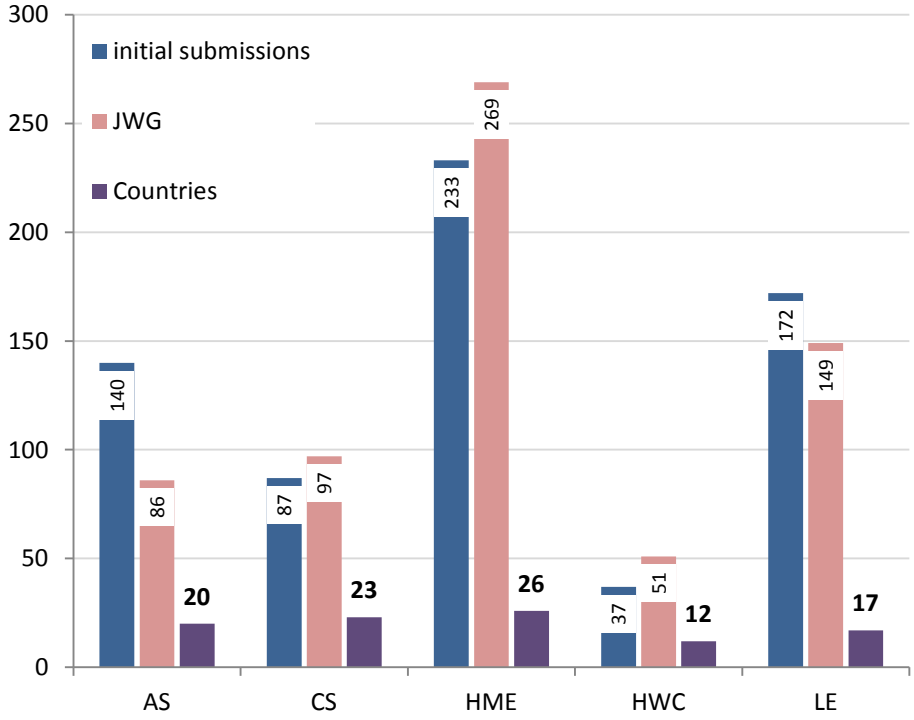
Policy options for subsequent finalisation

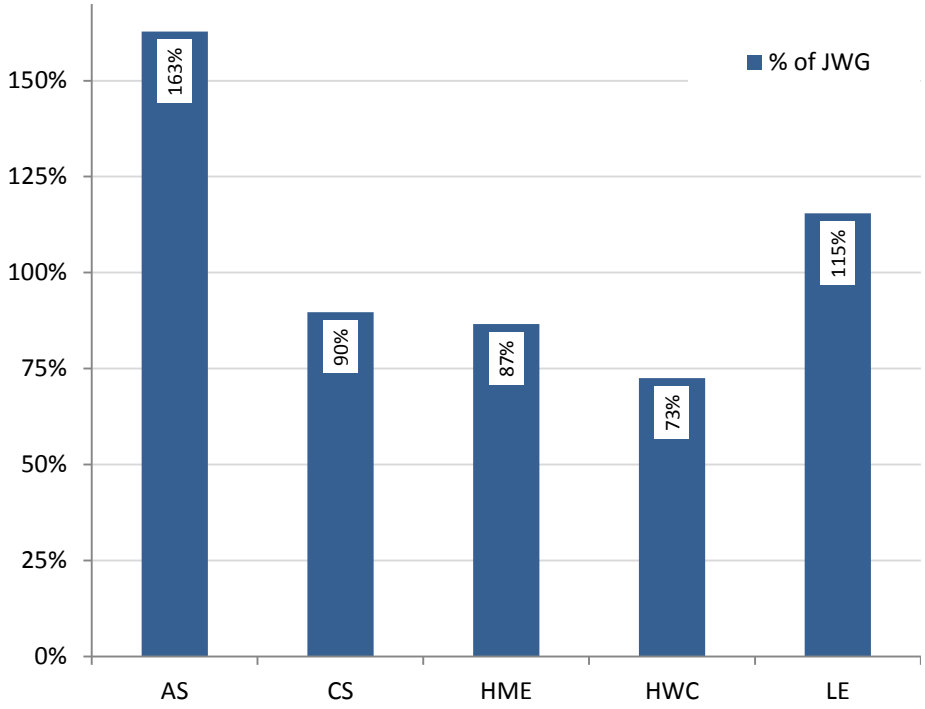
Data – Data collection exercise

Policy options for subsequent finalisation

Submissions received in 2017 in comparison to 2011



Submissions received in 2017 in comparison to 2011

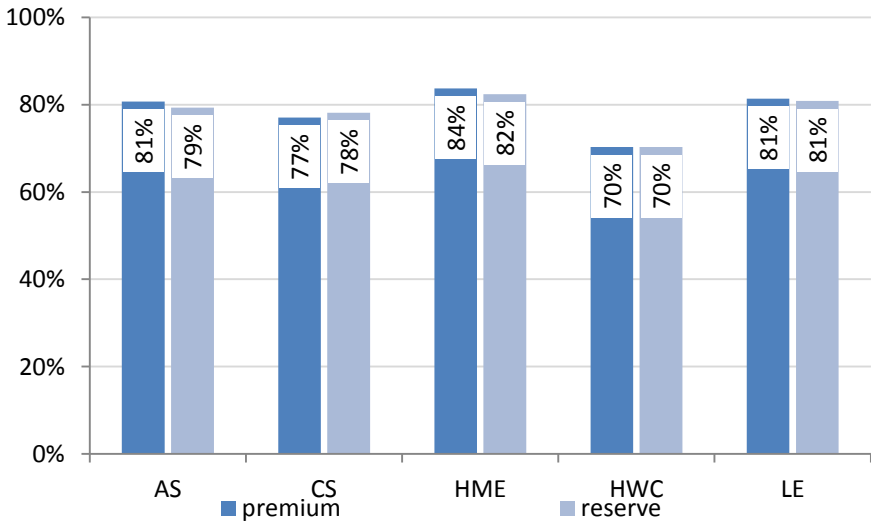


Data – Cleaning

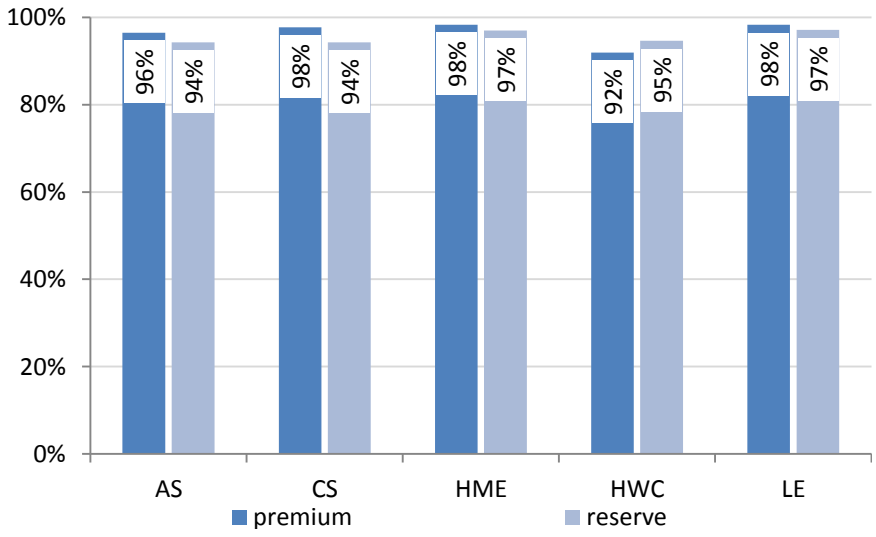
Policy options for subsequent finalisation

- Two sets of data
  - *restricted* set: exploitable raw data
  - *expanded* set: data corrected + restricted set
    - unit of values, negative values…

Percentage of initial submissions included for the restricted set



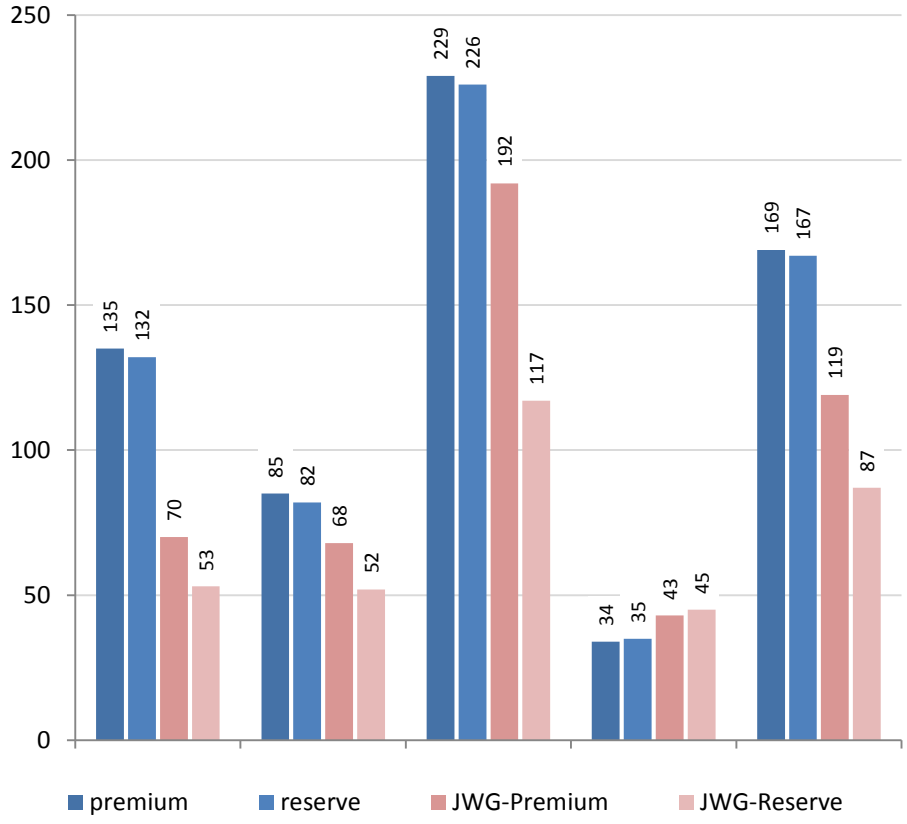
Percentage of initial submissions included in the expanded set



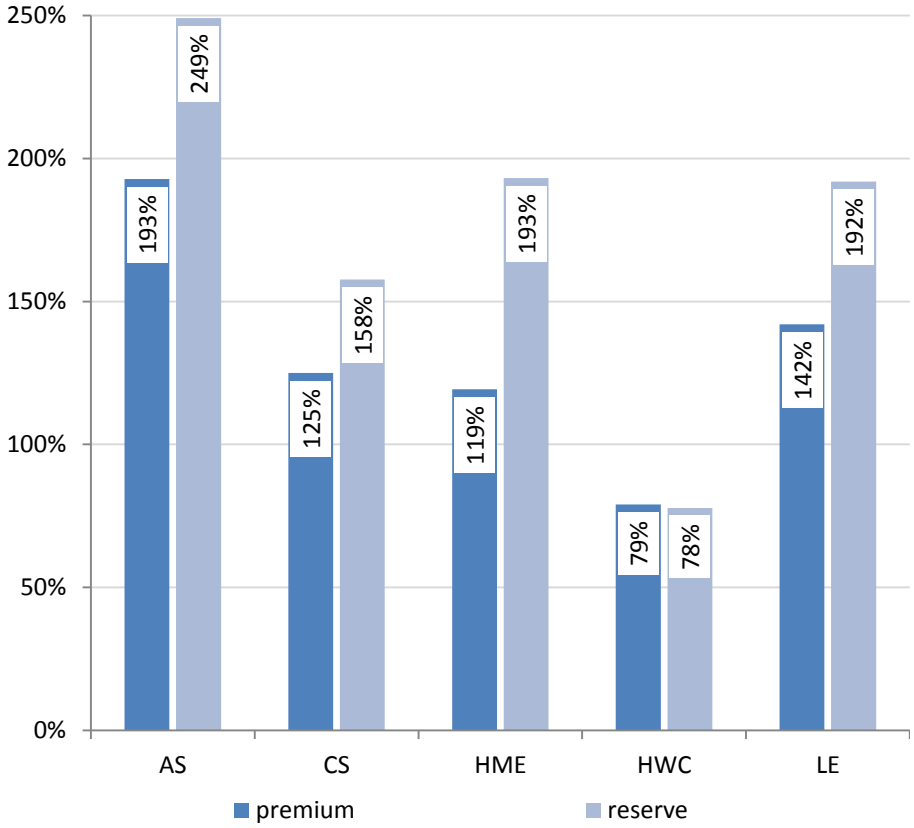
Data – Exclusion

Policy options for subsequent finalisation

Number of submissions included in the expanded set



Number of submissions in the expanded set compared to JWG



Data - Type of data used

Policy options for subsequent finalisation

- Data requested
  - raw data gross of reinsurance;
  - adjusted data gross of reinsurance, excluding catastrophe loss; and
  - data net of reinsurance;
  - adjusted data net of reinsurance, excluding catastrophe loss;
  - impacts of salvage and subrogation.

- Calibration performed on data gross of reinsurance
  - Sufficient data only received for this kind of data
  - Premium: loss at the end of the first year

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Policy options for subsequent finalisation

- Introduction
- Data
- General approach for assessing sigma
  - Methods applied
  - Outliers
  - European sigma
  - Rescaling
- Preliminary results

General approach - Methods applied

Policy options for subsequent finalisation

- Same methodologies as JWG in 2011

- Parametrization
  - Normal and Lognormal
  - Premium: two different definitions of the lognormal variance

General approach - Outliers

Policy options for subsequent finalisation

- Automated exclusion of outliers
  - For a given LoB and a given methodology
  - This is performed three times
  - Reduce volatility

- Principle
  1. Perform the calibration
  2. Eliminate observations that generated outlying standardised residuals
  3. Create a new subset

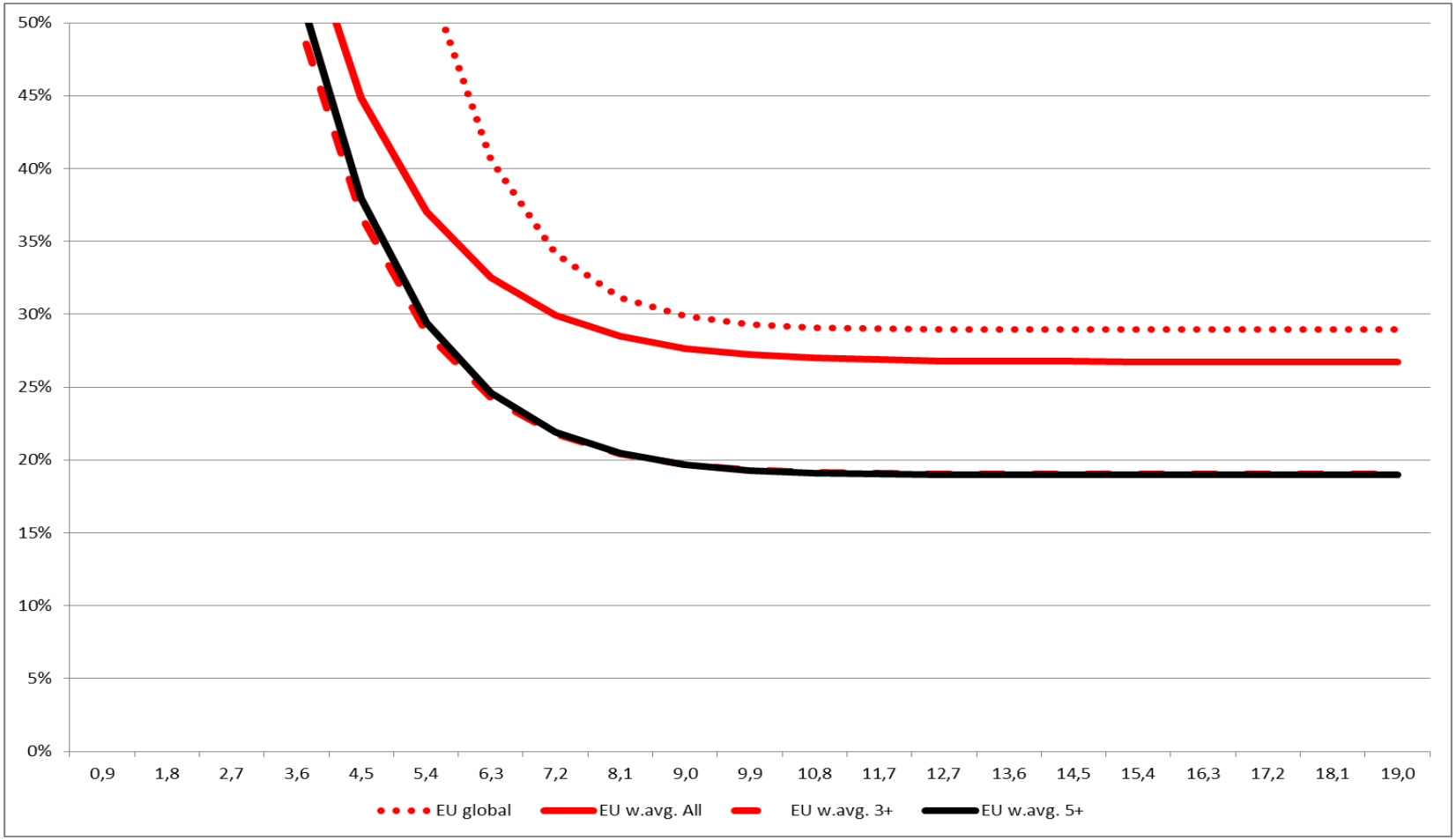
General approach – European sigma

Policy options for subsequent finalisation

- Two approaches to derive a European sigma
  - Method 1: Using all data received at once to perform the calibration, rescaled to cover 95% of policyholders or 65% of portfolios.
    - **Europe is one unique market**
  - Method 2: First perform calibration on the national markets, rescaled at the European 95% size portfolio and then aggregate with a weighted average.
    - **Europe is an aggregation of the national market**
- The second approach was chosen for the advice by the JWG in 2011.

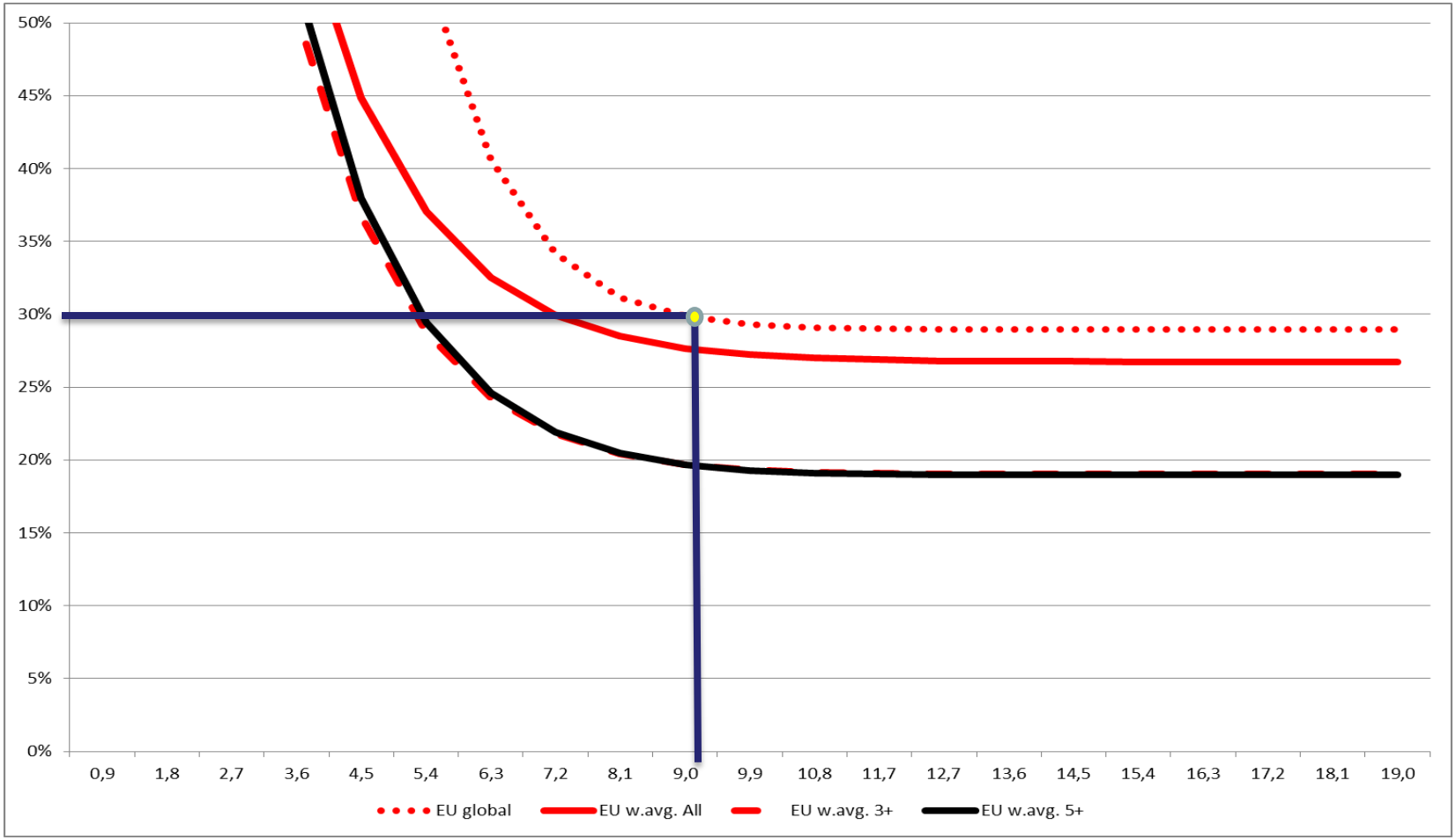
General approach - Rescaling

Policy options for subsequent finalisation



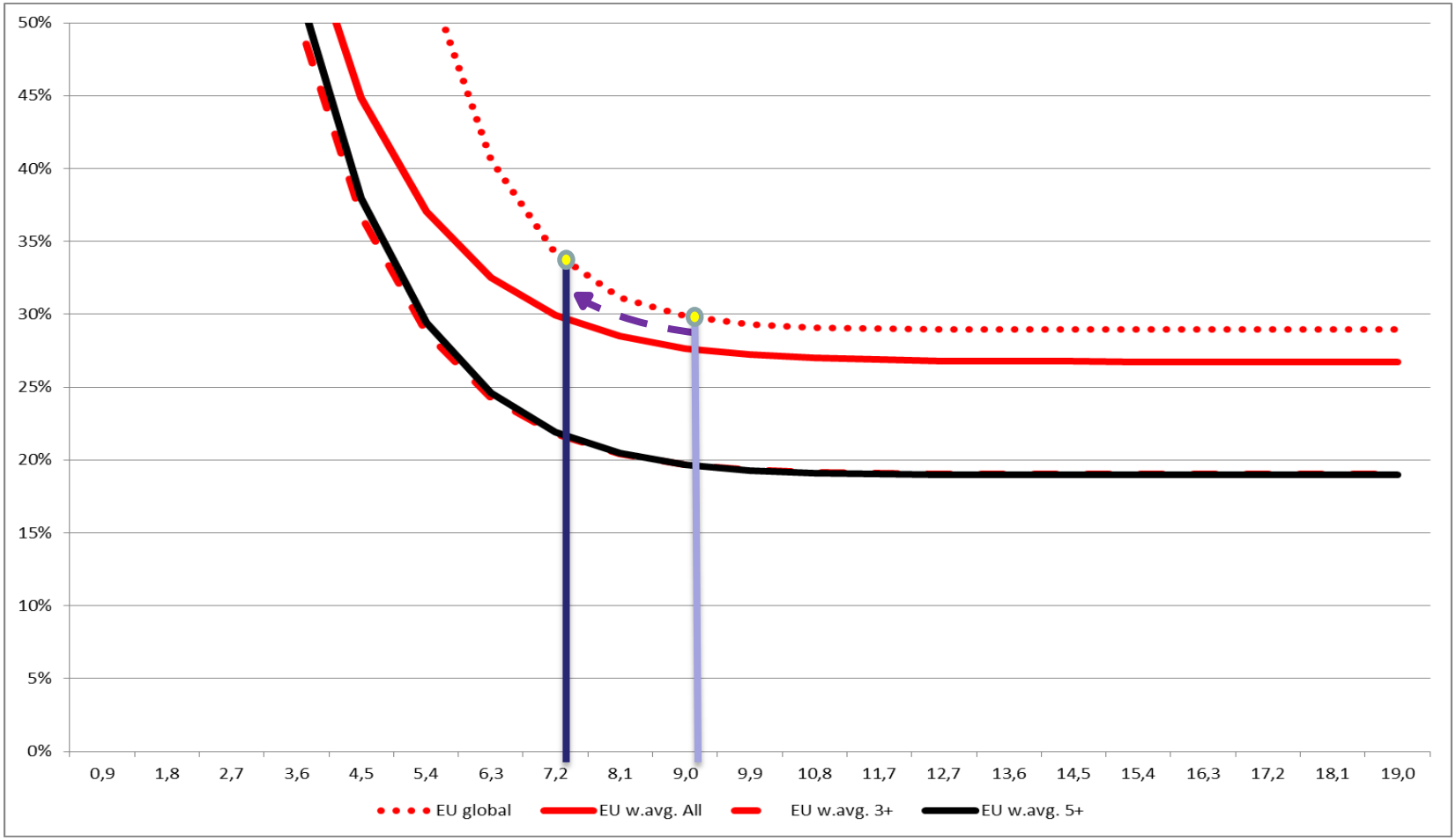
General approach - Rescaling

Policy options for subsequent finalisation



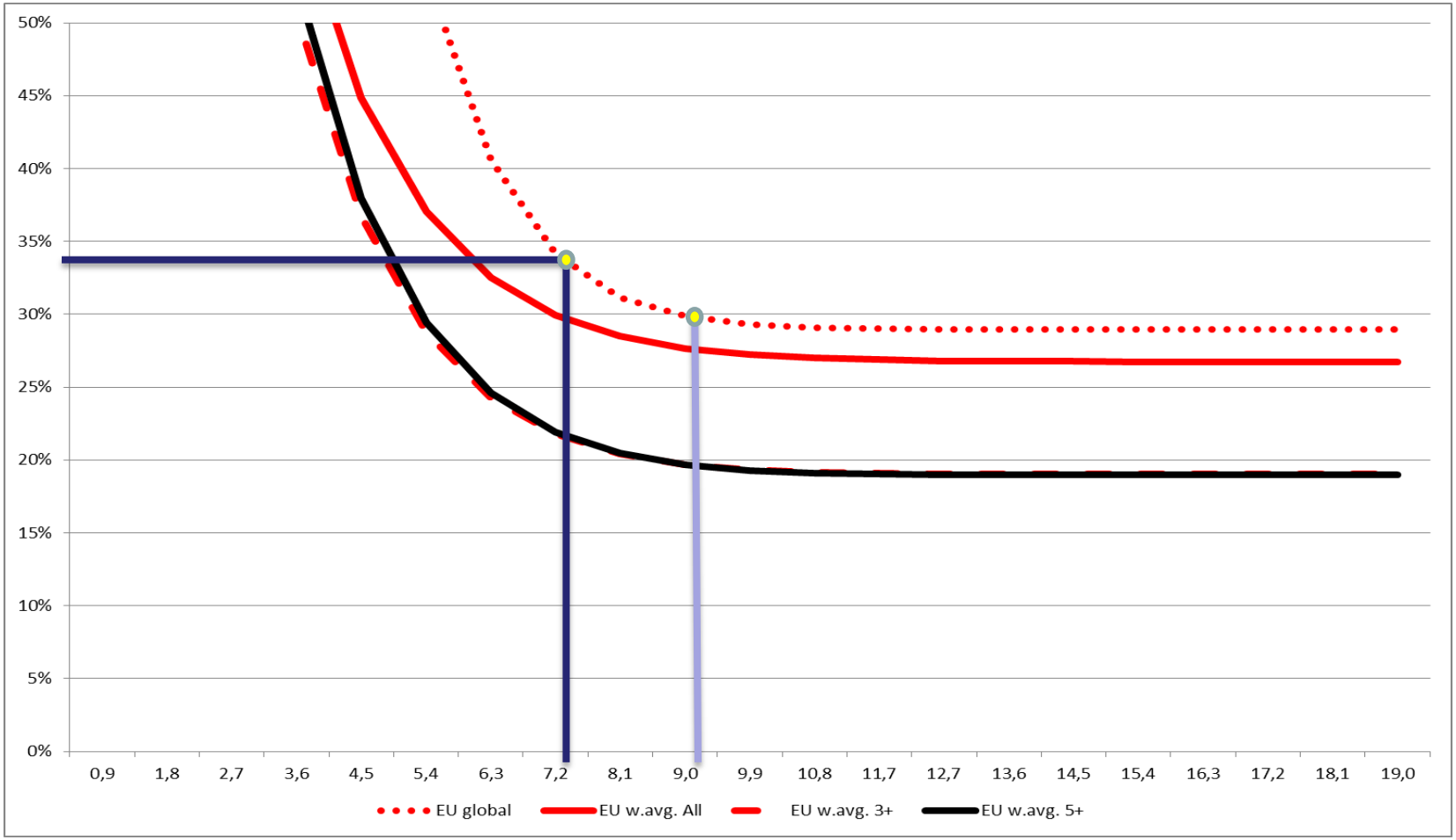
General approach - Rescaling

Policy options for subsequent finalisation



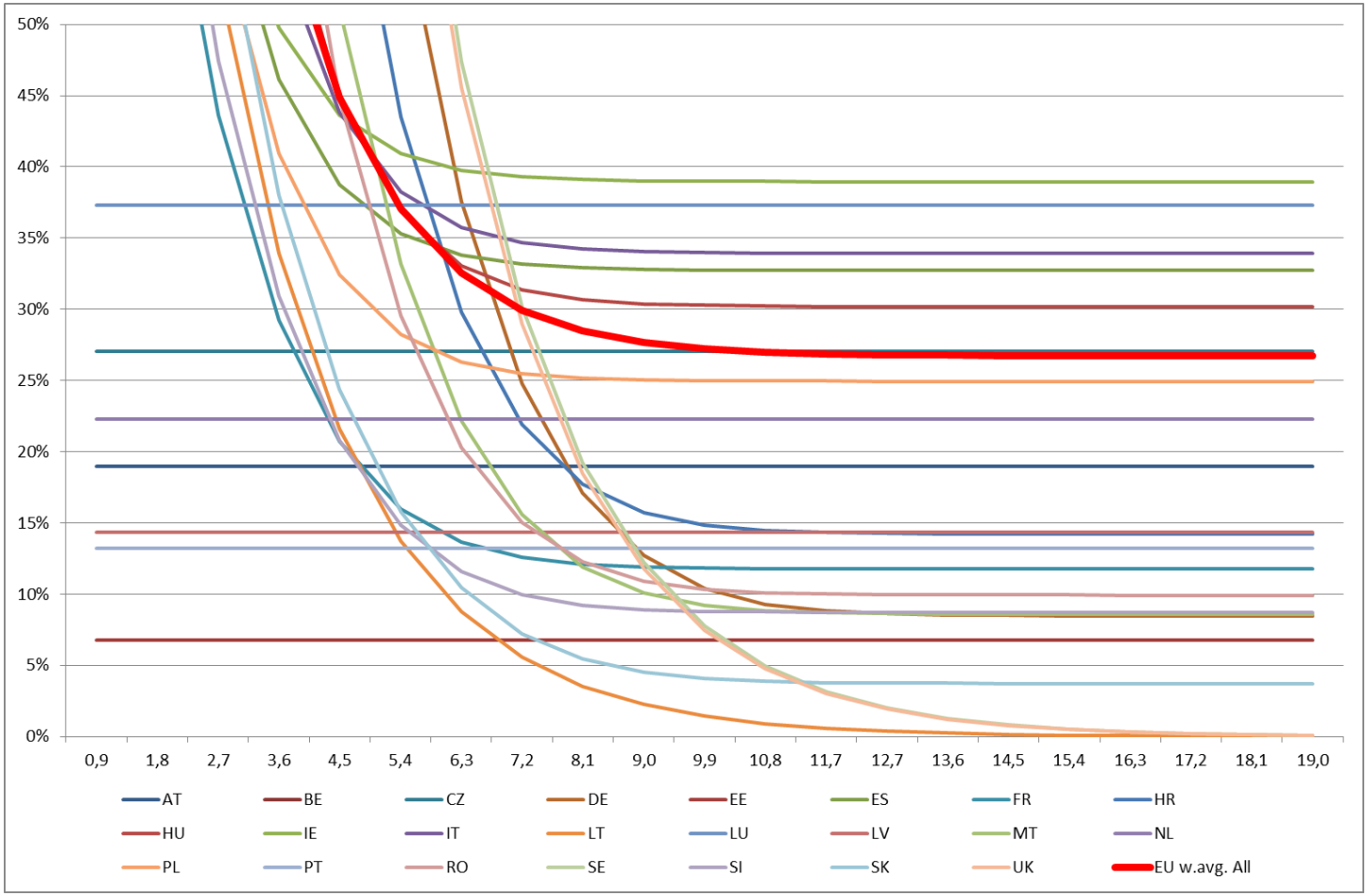
General approach - Rescaling

Policy options for subsequent finalisation



General approach - Rescaling

Policy options for subsequent finalisation



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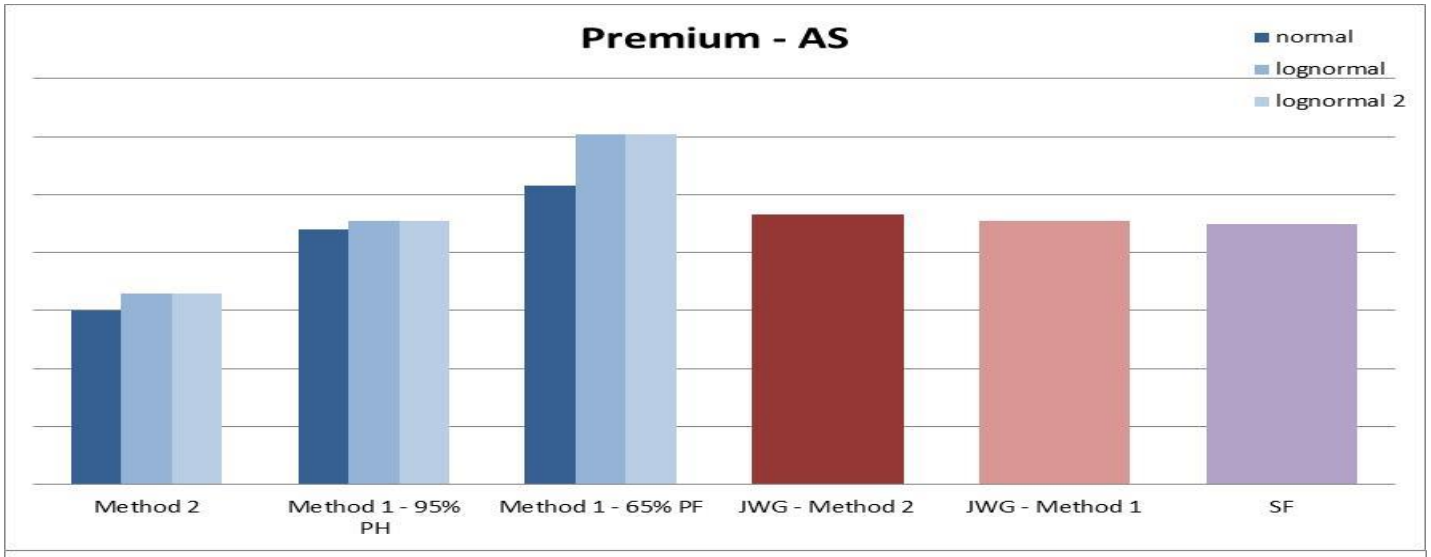
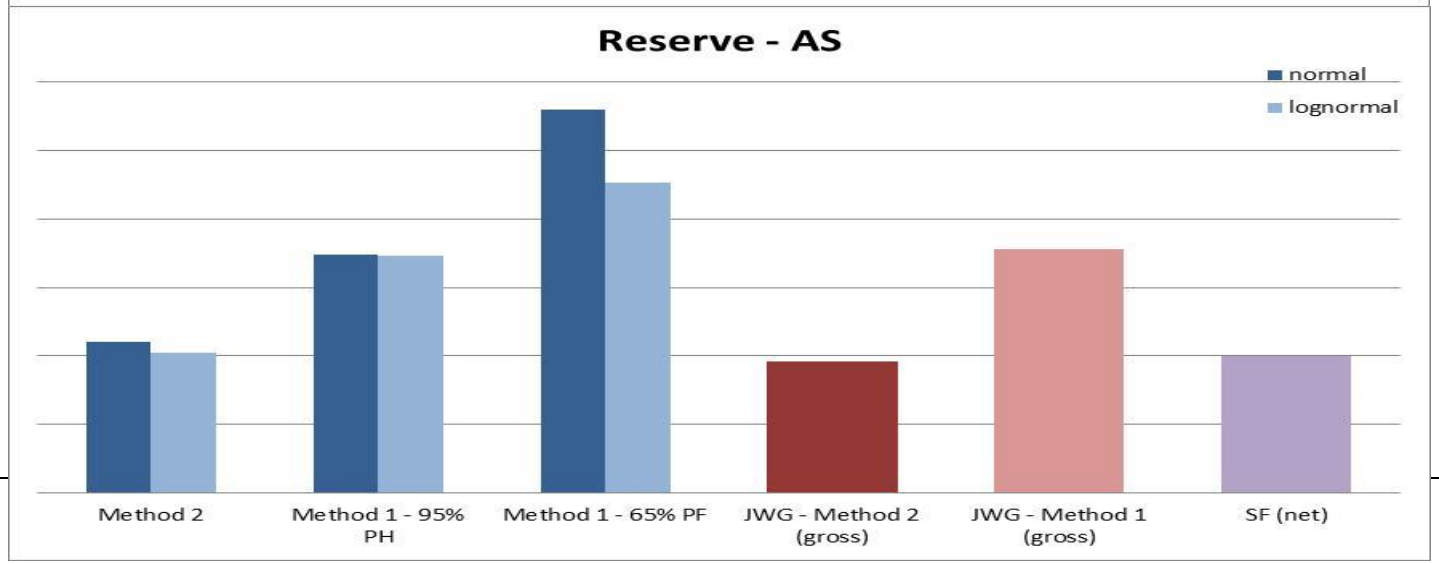
- General approach for assessing sigma
- Preliminary results
  - AS
  - CS
  - HME
  - HWC
  - LE

Preliminary results - AS

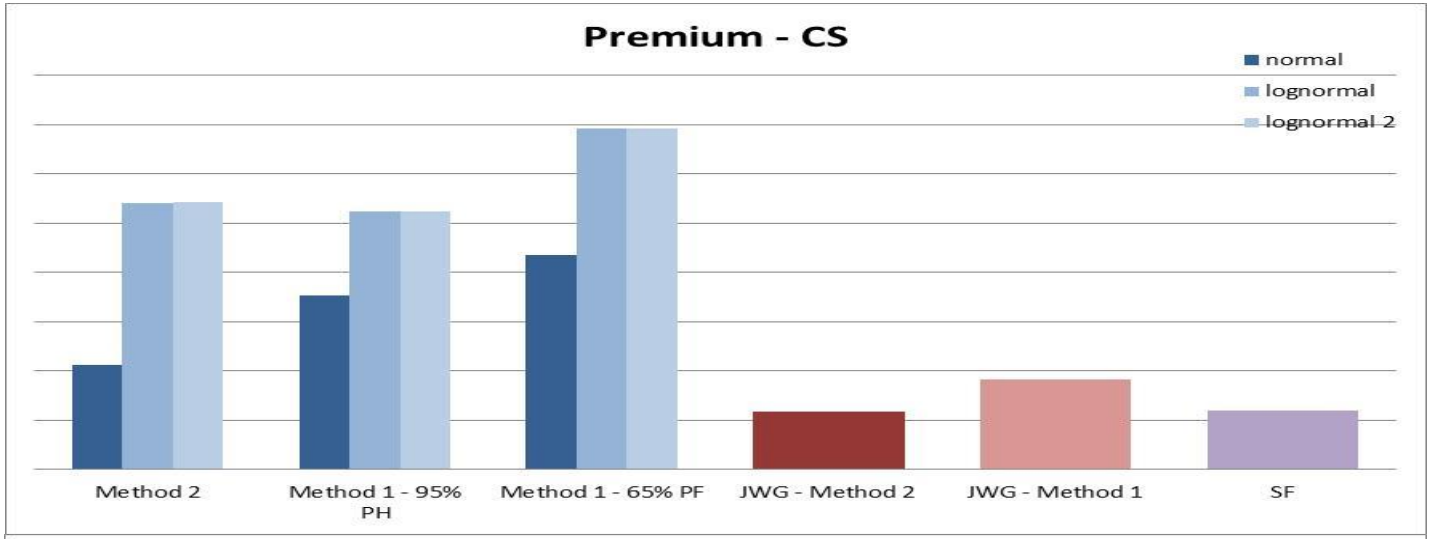
Policy options for subsequent finalisation

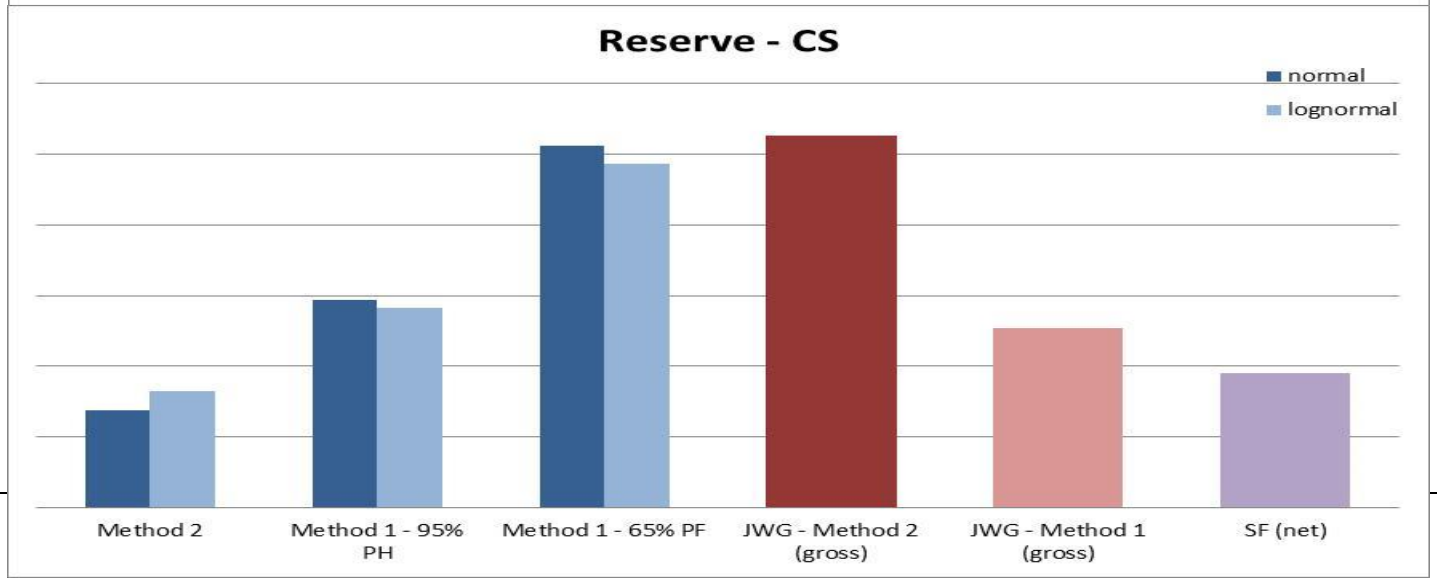




Preliminary results - CS

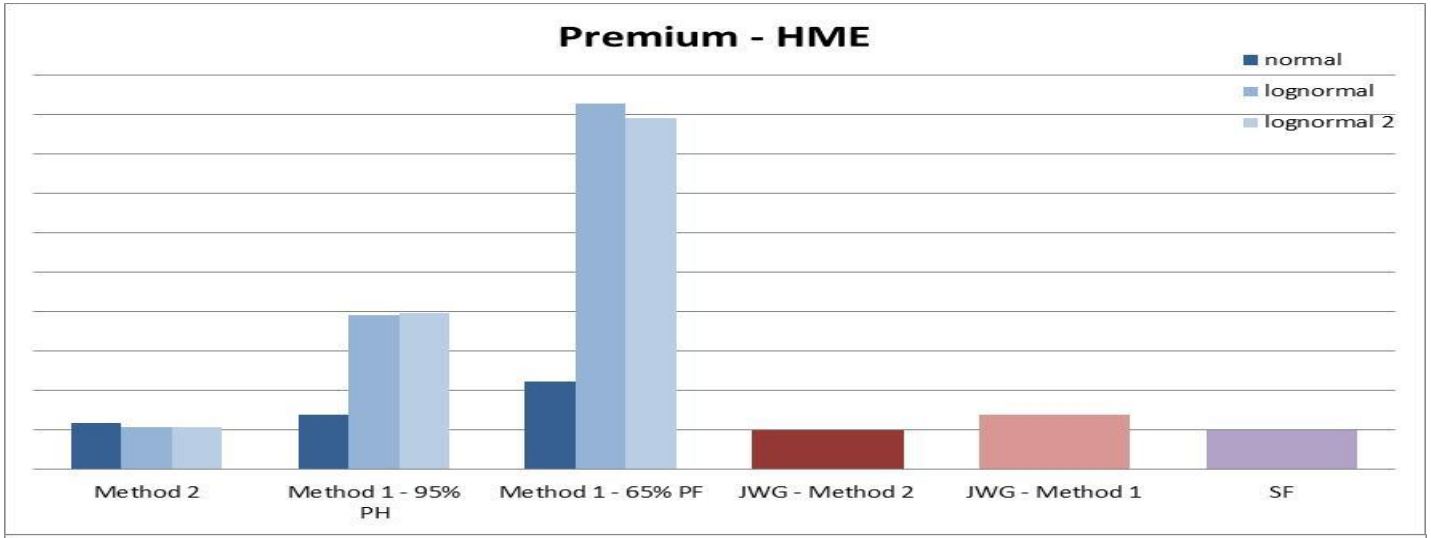
Policy options for subsequent finalisation

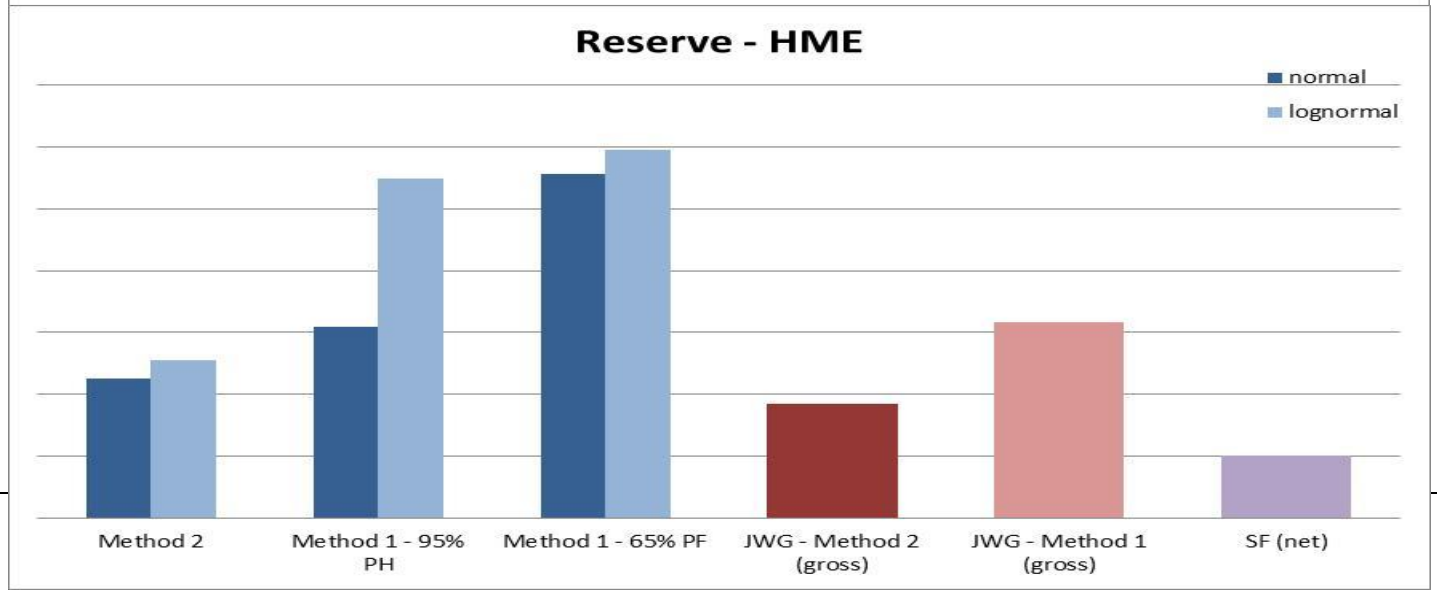




Preliminary results - HME

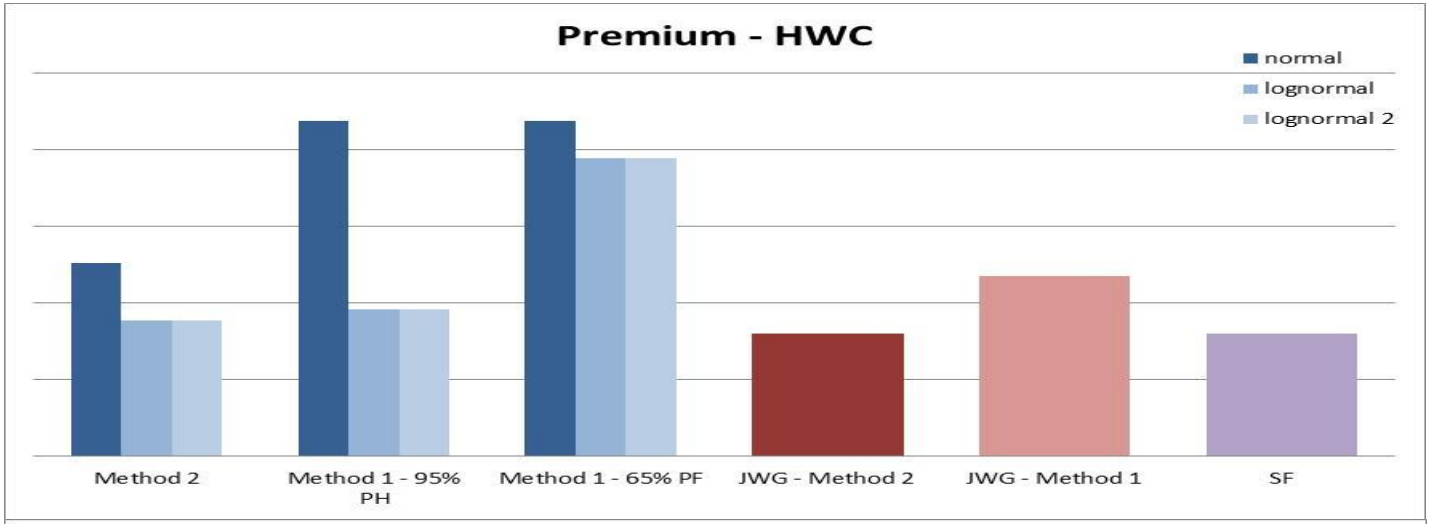
Policy options for subsequent finalisation

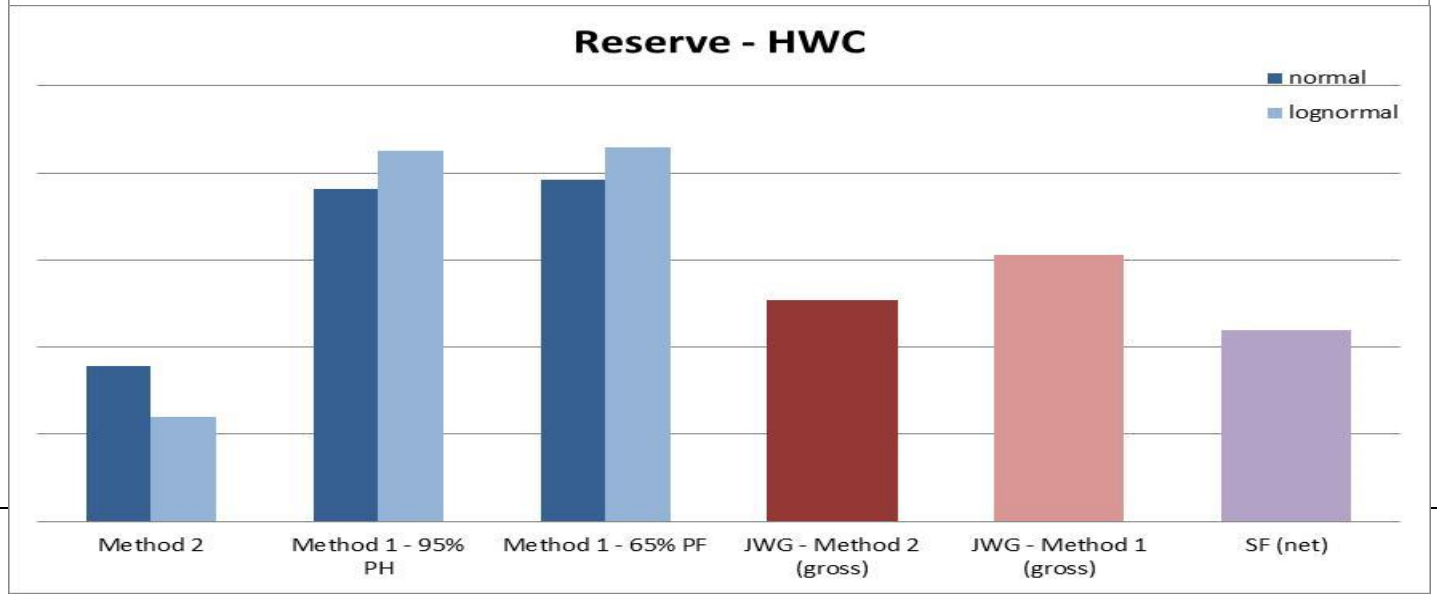




Preliminary results - HWC

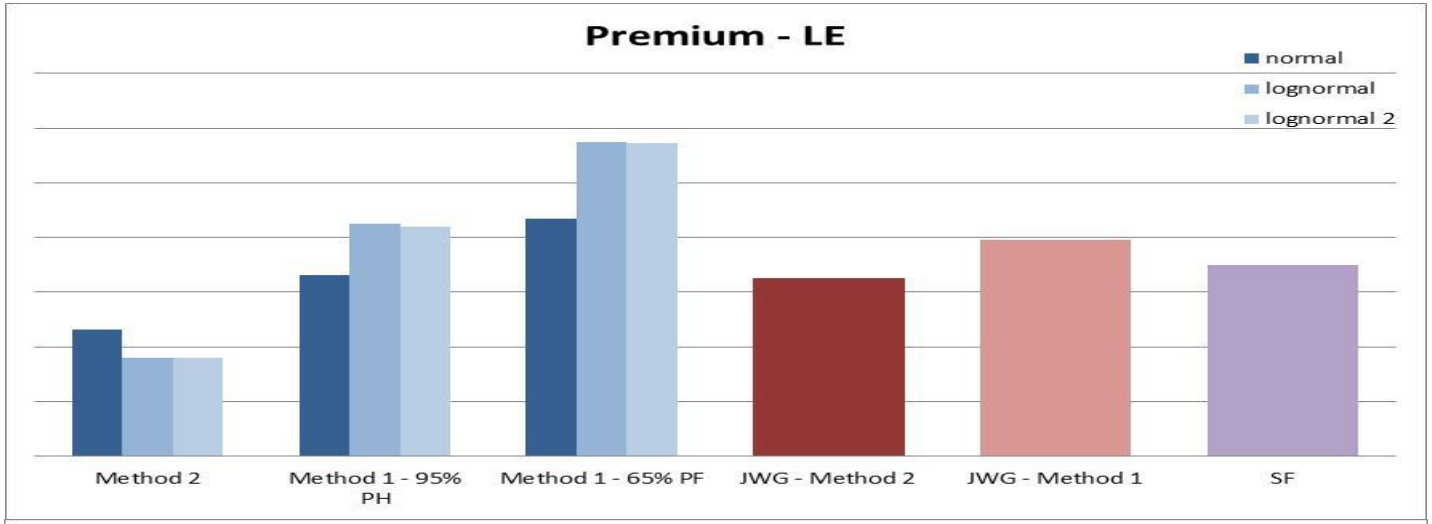
Policy options for subsequent finalisation

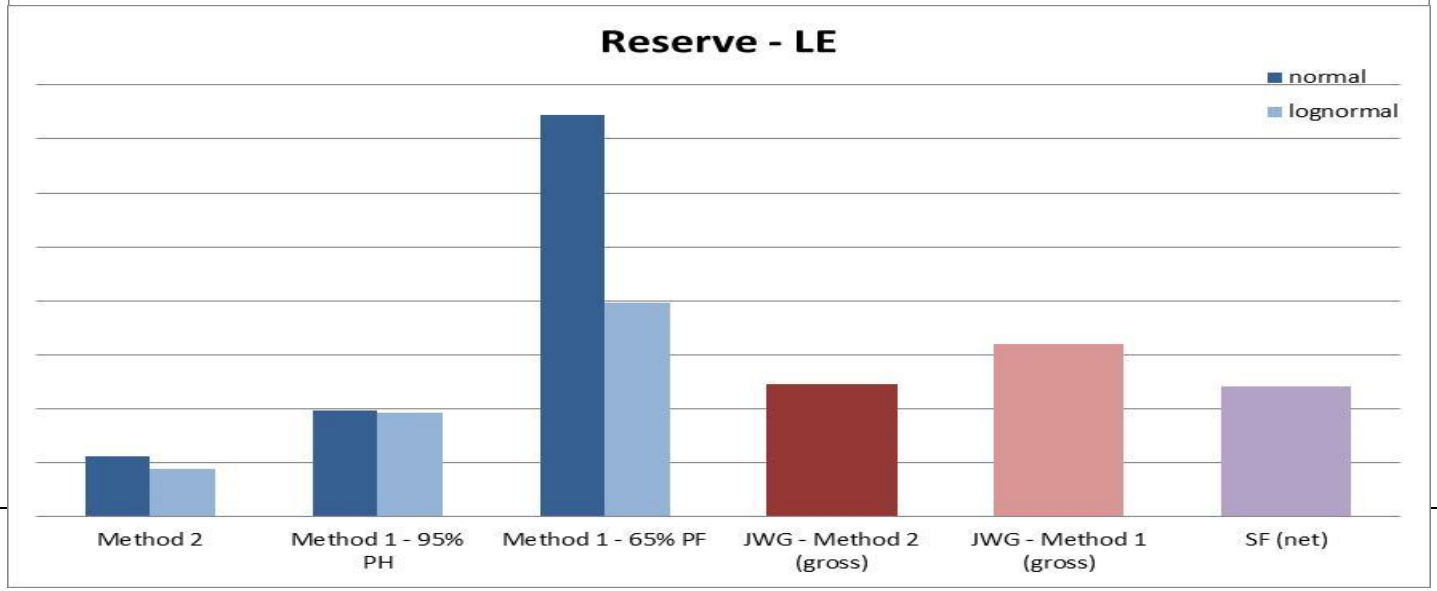




Preliminary results - LE

Policy options for subsequent finalisation





Volume measure for premium risk

Volume measure for premium risk

Policy options for subsequent finalisation

Call for advice of European Commission:

- *"the definition of the volume measure for premium risk should be reassessed for continued appropriateness"*

Article 105(2) of the Solvency II Directive:

- "[The SCR for non-life UW risk] *shall take account of the uncertainty in the results of insurance and reinsurance undertakings related to the existing insurance and reinsurance obligations as well as to the new business expected to be written over the following 12 months"*

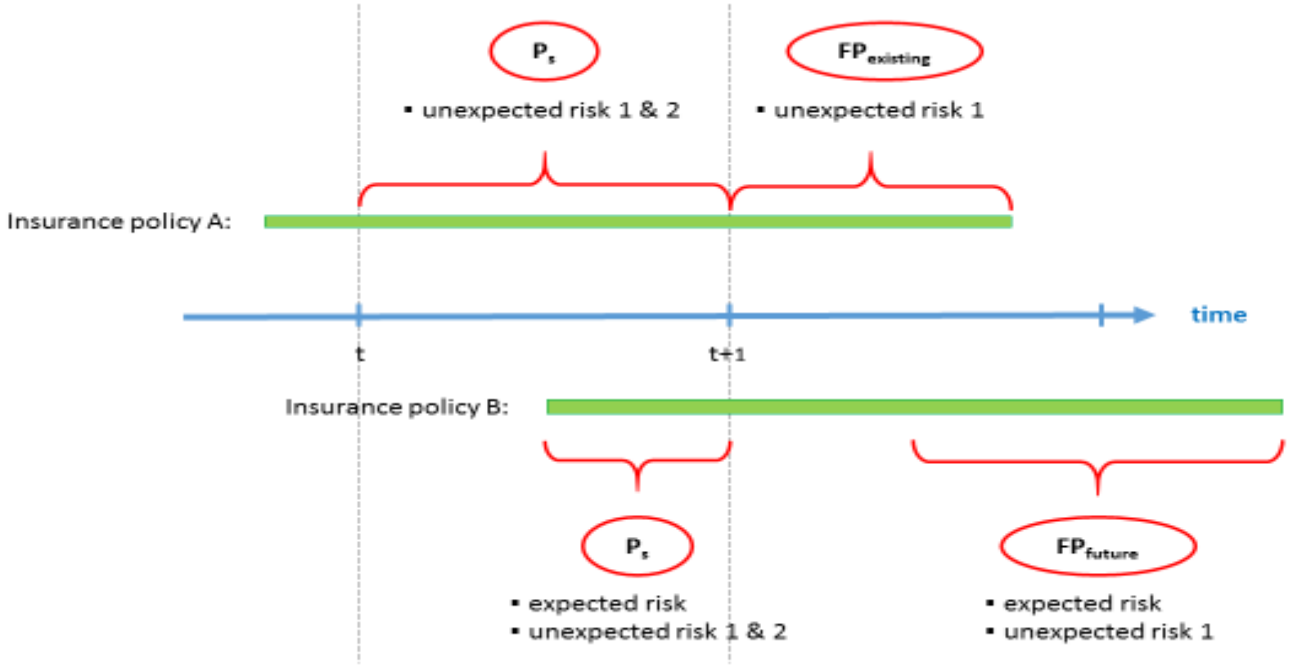
Article 101(3) of the Solvency II Directive:

- "[The SCR] *shall cover existing business, as well as the new business expected to be written over the following 12 months. With respect to existing business, it shall cover only unexpected losses"*

Expected and unexpected risks

Policy options for subsequent finalisation

- Expected risk: e.g. underpricing of insurance policies
- Unexpected risk:
  1. permanent rise in costs (e.g. inflation, change in legal environment)
  2. temporary rise in costs (e.g. large event)



Gap in FP_future

Policy options for subsequent finalisation

- FP_future excludes the "*premiums to be earned during the following 12 months after the initial recognition date*"
- This introduces a gap in FP_future that reflects the absence of unexpected risk coming from temporary rise in costs
- We are considering to:
  - "Fill the gap" and exclude only "*premiums to be earned during the following 12 months ~~after the initial recognition date~~*"
  - Introduce adjustment factors to reflect lower risk of FP_future and FP_existing
  - Data received beginning of September being analysed for calibration of these adjustment factors, with the aim to minimise changes in SCR

Other considerations

Policy options for subsequent finalisation

- On the stability of the volume measure for premium risk throughout the year
- Whether there needs to be further differences between 1-year and multi-year policies
- Clarifying that contract boundaries apply to FP_existing and FP_future calculations
- Whether new reinsurance arrangements should affect P(last,s)
  - Article 116(4) already allows not to take account of earned premium of last year under specific conditions

Interest rate risk

Agenda

Policy options for subsequent finalisation

1. Main stakeholder comments
2. Methodologies analysed
3. Conclusion

Main stakeholder comments

Policy options for subsequent finalisation

- The majority of stakeholders agreed with the main issues identified in the discussion paper
- The majority of stakeholders consider the historical EIOPA RFR data as a suitable data set to perform the calibration
- Several stakeholders argued that the risk-free curve should only be shocked up to the last liquid point (LLP) and afterwards an extrapolation with the Smith- Wilson technique should be applied
- The main methodological proposal was a shift approach
  - Some stakeholders proposed a relative shift approach
  - Other stakeholders proposed a lognormal shift approach

Methodologies analysed

Policy options for subsequent finalisation

- EIOPA has thoroughly analysed the following three methodologies:

1. Shift-approaches (relative and lognormal shift) (Method 1)
2. A Minimum Shock approach with a static floor (Method 2)
3. A combined approach (Method 3)

Shift approaches

Policy options for subsequent finalisation

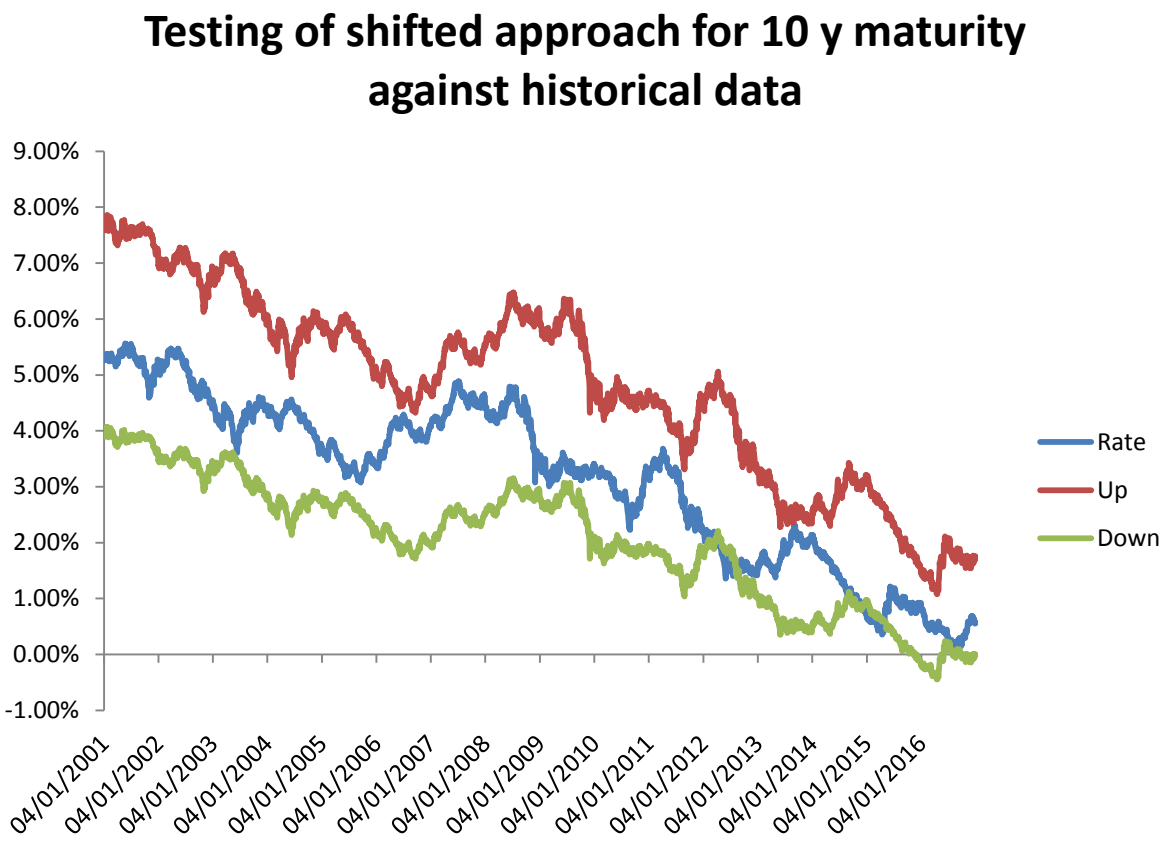
- Focus on a simple relative shift approach with a constant shift parameter vector

$$r_t^{up,down} = (r_t - \theta) * (1 \pm s^{shift,up,down}(\theta)) + \theta$$

- The lognormal shift approach was analysed as well
- A calibration of the shift-parameter for different currencies, several sensitivity analysis and an in-depth backtesting was performed
- Sensitivity analyses show
  - Shifted approach is similar to relative approach in moderate and high yield environment
  - Shifted approach much more conservative in low yield environment
  - Sensitivity towards shift parameter rather low to modest

Backtesting for the relative shift approach

Policy options for subsequent finalisation



Backtesting Methodology and Interpretation

Policy options for subsequent finalisation

- **Methodology**
  - Backtesting is based on daily historical observations of the risk-free curves
  - The realized risk-free curve is compared with the stressed interest rate curves from the previous year
  - The model parameters are calibrated on 30.12.2016 and were not dynamically recalibrated

- **Interpretation**
  - EIOPA does not count every single daily breach
  - But counts breaches in terms of periodic clusters
  - For the backtesting example on the previous figure, this would mean that under the calibrated relative shifted approach the stressed interest rate down curve breached the realized risk-free curve 3 times, in 2011, 2014 and 2016
  - If a specific model systematically results in more than one breach according to the clustering argument for different currencies and tenor points, the model is considered inappropriate to measure the 1 in 200 year event

  -> the shifted approaches are not sufficiently prudent to measure the 1 in 200 year event

A Minimum Shock approach with a static floor (Method 2)

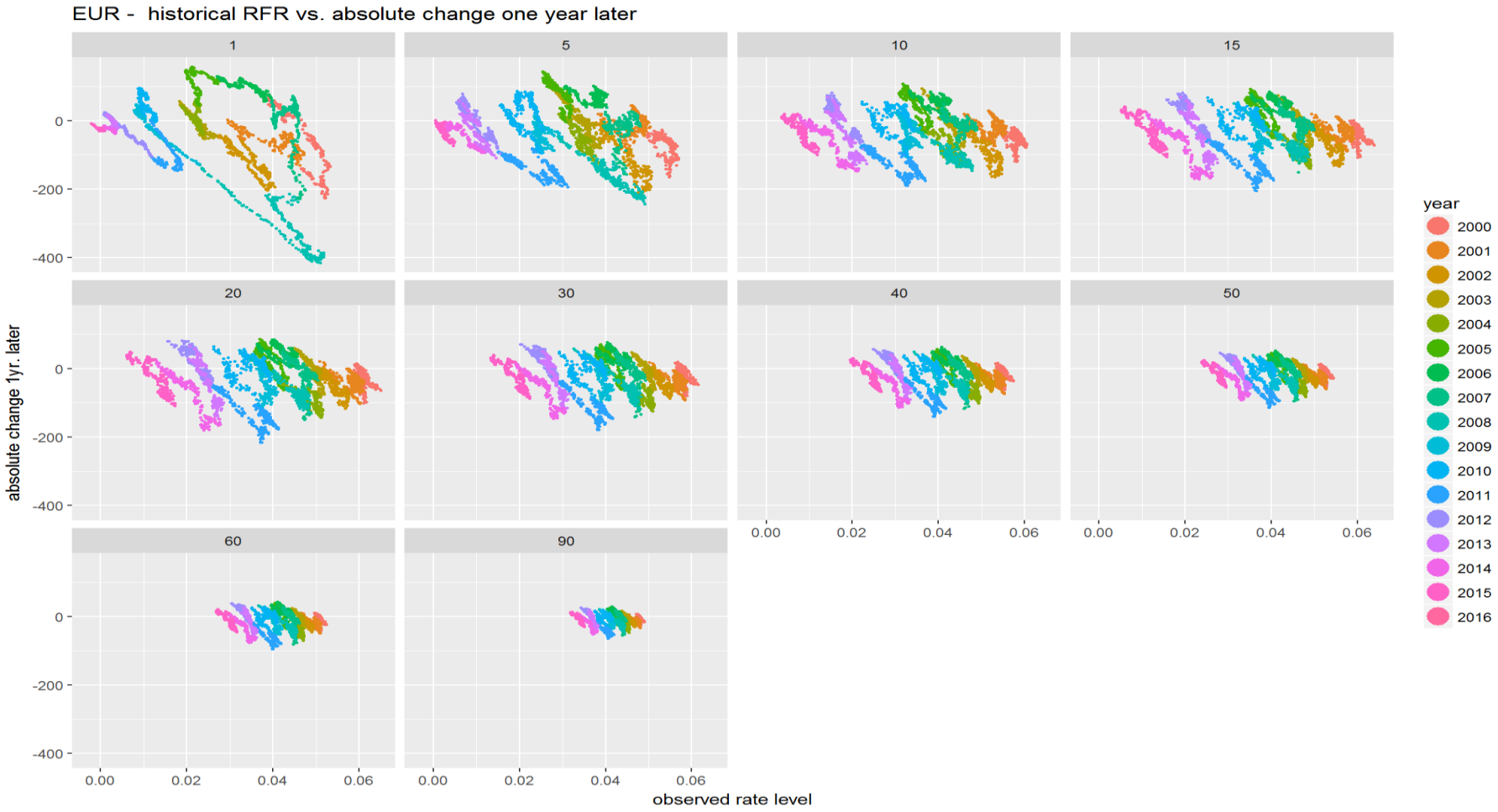
Policy options for subsequent finalisation

- The idea is to keep the current relative stress factors and to add a symmetric minimum shock
- $r_t^{down,minshock} = \max\left(floor(m), \min\left[r_t(m) - 2\% \,;\, r_t(m) \cdot \left(1 - s^{down}(m)\right)\right]\right)$
- $r_t^{up,minshock} = \max\left[r_t(m) + 2\% \,;\, r_t(m) \cdot \left(1 + s^{up}(m)\right)\right]$

- The 2% minimum shock is phased out after 20Y until 90Y
- The minimum shock was determined by a thorough analysis of the historical movements in interest rates
  - In particular, as the figure on the next slide indicates, substantial annual downward movements have been observed in a moderate-yield environment in the past
- An upward minimum shock of 2% is introduced to take account of the risk of a large increase of interest rates in a low yield environment
- A static (interest-rate independent floor) is introduced to take account of the fact that large negative interest rates have not been observed

Analysis of the historical movements of interest rates

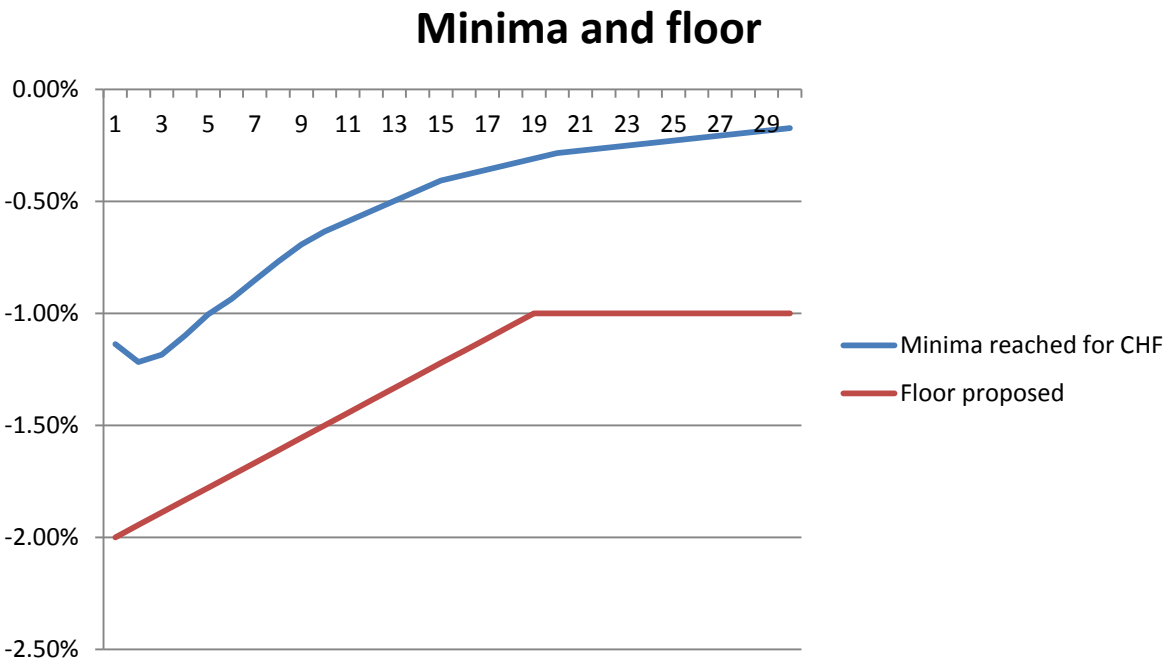
Policy options for subsequent finalisation



Interest rate floor

Policy options for subsequent finalisation

- The derivation was based on the lowest observed interest rate for different maturities and by adding a prudency margin
  - In fact these were observed for the CHF



A combined approach

Policy options for subsequent finalisation

- While the relative approach works fine in the high yield environment and the 2% minimum shock seems appropriate in the moderate yield environment, the 2% minimum shock might be challenged in the low yield environment to be overly prudent

- As the figure on slide 8 indicates large annual movements, particularly downward movements, have not been observed in the low yield environment
- A properly calibrated affine model seems to be a simple and risk-sensitive model for the low yield environment
- The following affine model was estimated on historical EIOPA RFR data

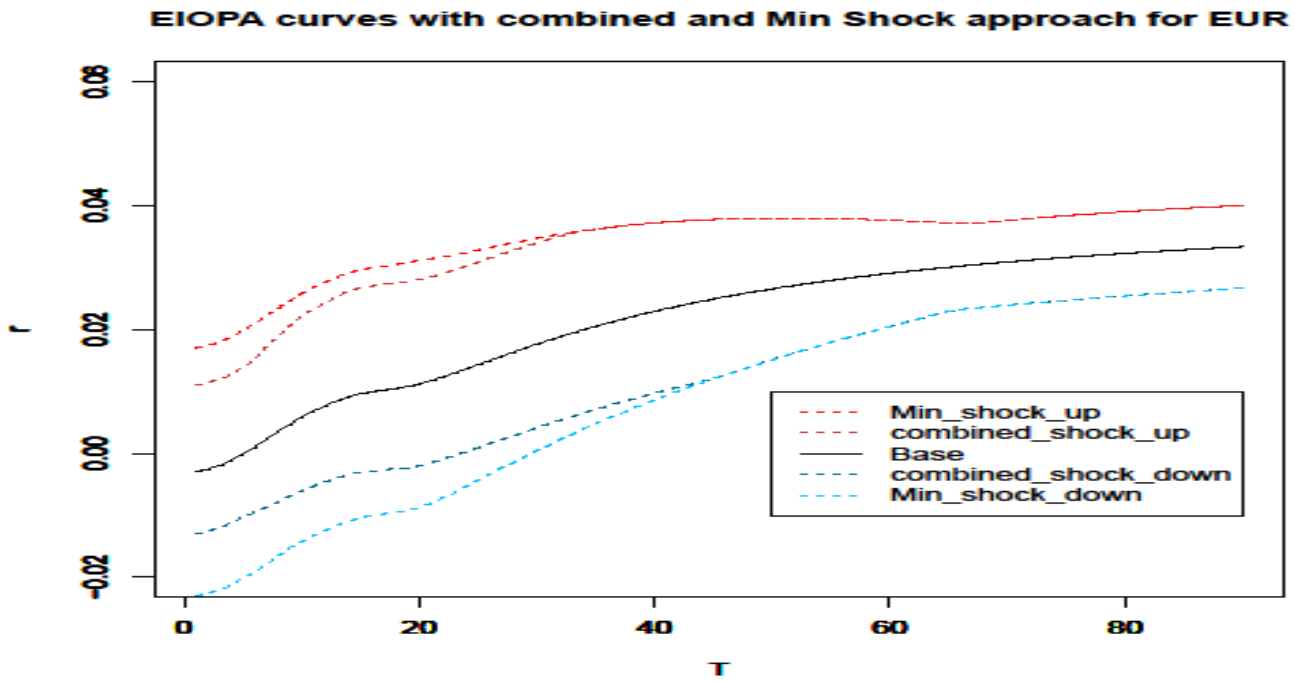
$$r_t^{down,affine}(m) = \min(r_t(m), r_t(m)\left(1 - s^{down}(m)\right)) - 1\%$$

$$r_t^{up,affine}(m) = \max(r_t(m), r_t(m)\left(1 + s^{up}(m)\right)) + 1.4\%$$

- The additive stresses (-1% and 1.4%) are phased out after 20Y until 90Y
- The comined approach is then defined by combining the affine model with Method 2
- $r_t^{down,combined}(m) = \max\left(r_t^{down,affine}(m)\ ;\ r_t^{down,minshock}(m)\right)$
- $r_t^{up,combined}(m) = \min\left(r_t^{up,affine}(m)\ ;\ r_t^{up,minshock}(m)\right)$

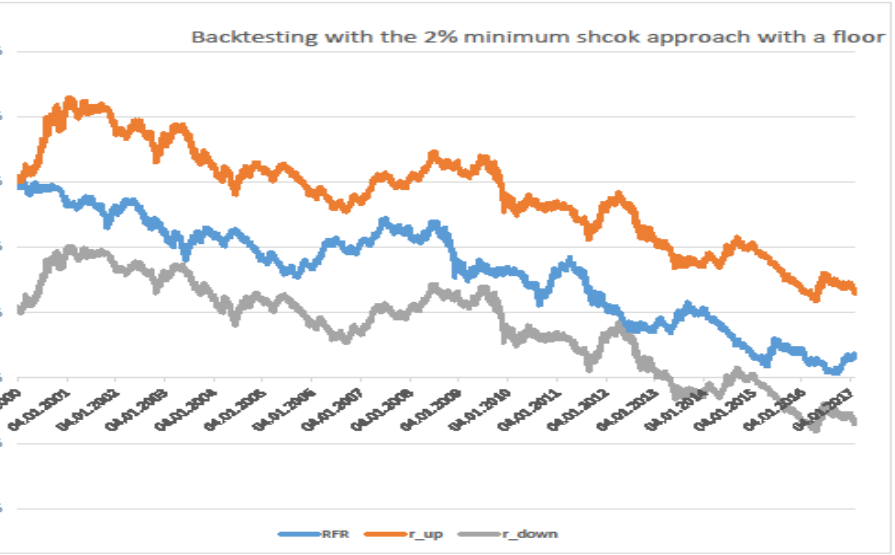
Comparison of Method 2 and Method 3

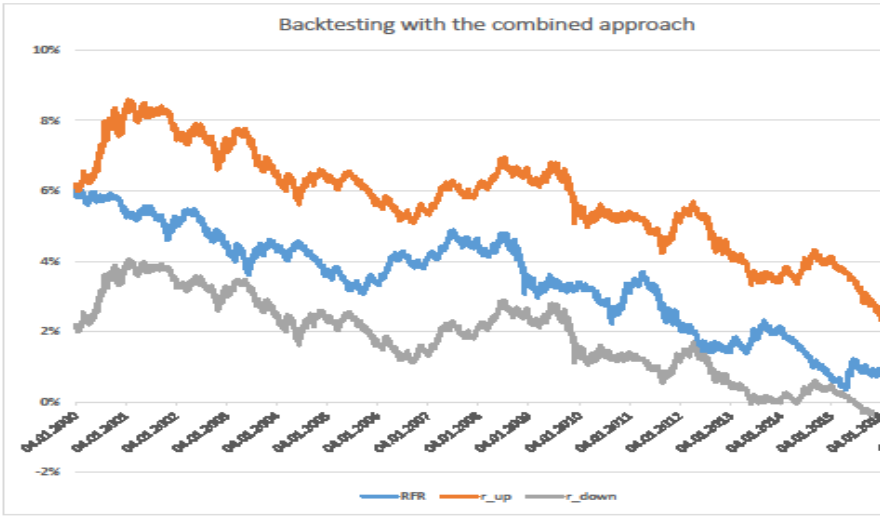
Policy options for subsequent finalisation



Backtesting for Method(2) and Method (3) for the 10Y EUR

Policy options for subsequent finalisation





Conclusion

Policy options for subsequent finalisation

- Backtesting analysis indicates that the shifted approach tends to underestimate interest risk in the interest rate down scenario
- Accordingly EIOPA would not propose this methodology for the interest rate risk submodule
- Method 2 and Method 3 do not suffer from this shortcoming
- The two methods are relatively simple and work equivalently in the high and medium yield environment, but differ in the low yield environment
- EIOPA intends to consult on either of the two methods as an appropriate candidate for the interest rate risk submodule.

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Longevity and mortality risks

Agenda

Policy options for subsequent finalisation

1. Methodology followed

2. Preliminary results

Methodology followed

Policy options for subsequent finalisation

- Given positive feedback on discussion paper, we followed the same methodology
  - Section 9 of https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-16-008_Discussion_Paper_on_SII_DR_SCR_Review.pdf
- To take account of model risks we use 2 models suggested by stakeholders: Lee Carter and Cairns-Blake-Dowd ("CBD")
- Data set:
  - Human Mortality Database
  - 7 most populated countries: ES, UK, IT, DE, FR, PL and NL
- Models calibrated for the ages 40-90 for CBD/LC and 0-90 for LC only, and years 1985-2013/2014/2015 depending on availability of most recent years
  - for DE the period starts at 1990 because that's the first year for combined (former) West/East German data

Methodology followed

Policy options for subsequent finalisation

Central to the methodology is the cohort life expectancy for age x denoted by:

$$e_x(t) = \frac{1}{2} + \sum_{k=1}^{\infty} \prod_{s=0}^{k} \left(1 - q_{x+s}(t+s)\right)$$

Or in short:

$$e_x(t) = \frac{1}{2} + \sum_{k=1}^{\infty} {}_k p_x(t)$$

Methodology followed

Policy options for subsequent finalisation

- For each mortality model (LC, CBD) and for each country (ES, UK, IT, DE, FR, PL and NL) we simulated 5000 cohort mortality tables
- Using these simulated tables we calculated the life expectancy $e_x(t)$ for each age (40,…,120) and each simulation
- Based on the 5000 simulated life expectancies for each age we calculated the 0.5%- and 99.5%-percentiles of the simulated life expectancies for each age

Methodology followed

Policy options for subsequent finalisation

- For the next step we introduce the shocked life expectancy, denoted by $e_x^h(t)$:

$$e_x^h(t) = \frac{1}{2} + \sum_{k=1}^{\infty} \prod_{s=0}^{k} \left(1 - (1 + h(x)) \times q_{x+s}(t+s)\right)$$

- Each future mortality probability is multiplied by a factor 1+h(x), which is **only** dependent on the age x at start of the valuation.
- Note1: for the current longevity shock for the standard formula it holds that: h(x) = -20%, i.e. the current longevity shock is not **age independent**

Methodology followed

Policy options for subsequent finalisation

- Note2: the proposed methodology allows introducing increased granularity with respect to the age of the insured life

- In the next step the h(x)-scaling factor for each age is being solved numerically according to the following equations:

- For longevity: $e_x^h(t) = e_x^{99.5\%}(t)$

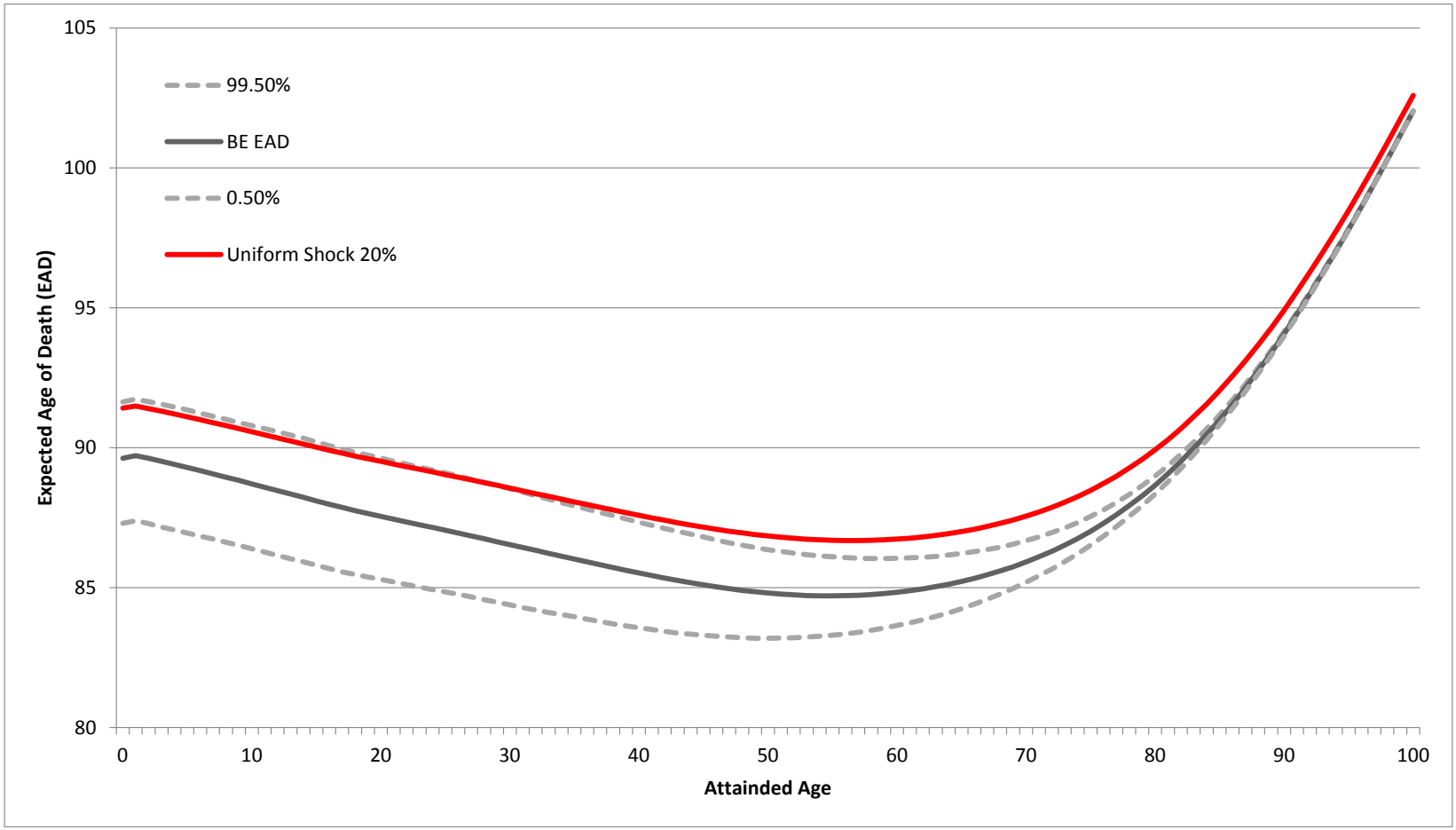
  where $e_x^{99.5\%}(t)$ is the 99.5% percentile of the simulated life expectancies

- For mortality: $e_x^h(t) = e_x^{0.5\%}(t)$

  where $e_x^{0.5\%}(t)$ is the 0.5% percentile of the simulated life expectancies

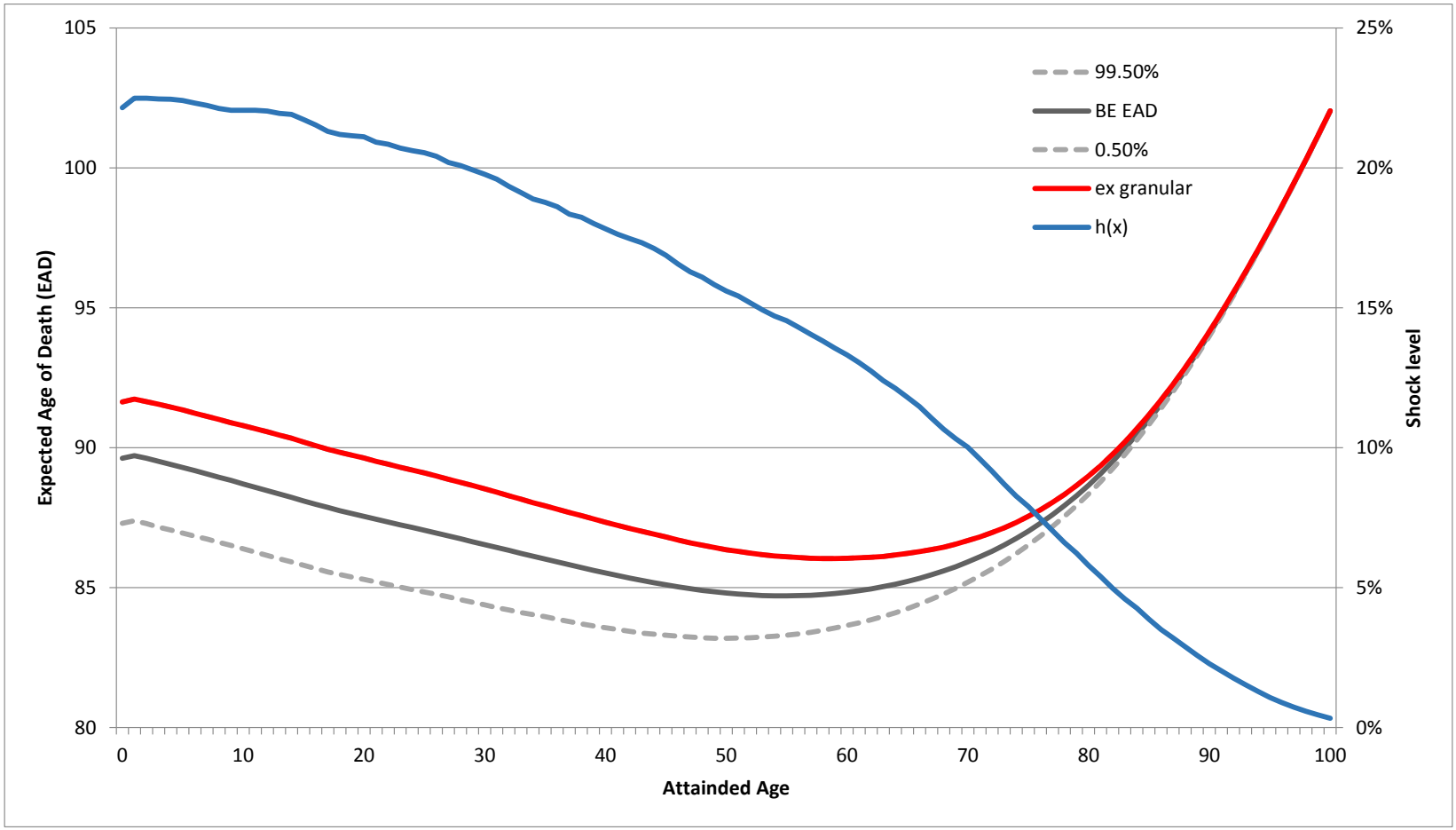
Methodology followed

Policy options for subsequent finalisation



Methodology followed

Policy options for subsequent finalisation



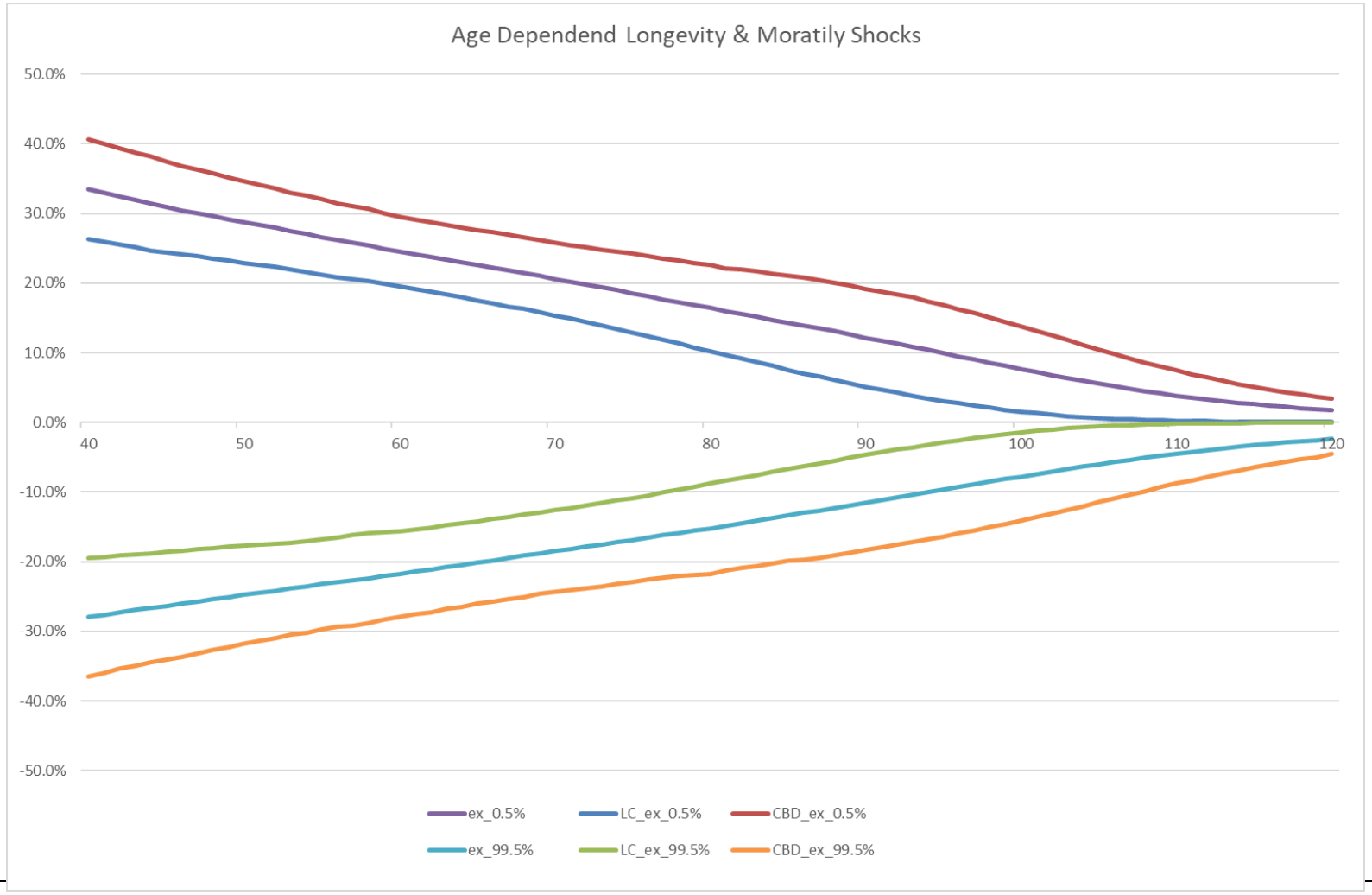
Preliminary results

Policy options for subsequent finalisation

- For each model, a unique EU stress is derived by averaging the h(x) of each of the 7 countries
- The average is weighted by the population
- We get one h(x) for LC and one for CBD
- We average them to take into account the model error

Preliminary results

Policy options for subsequent finalisation



Preliminary results and other considerations

Policy options for subsequent finalisation

- Current longevity stress of 20% is assumed to be for age 60 years old: results confirm this stress
- Prudency factor may be added to take account of:
  - The fact that general population data is not the same as insured population
  - Events that are not in the data, such as development of health care
- Whether to add more countries to be more representative
- Whether to advice on age-dependent shocks
  - Stakeholders' feedback was mixed because of the added complexity
- Whether to produce shocks that depend on the remaining term to maturity of a policy: complexity would be increased

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Look Through approach

Second part of look-through advice

Policy options for subsequent finalisation

- EIOPA is asked to review the simplification provided for the look-through approach (**Article 84(3) of Regulation (EU) 2015/35**).

- In particular, EIOPA is asked to **provide information** on investments by insurers through collective investment undertakings and other investments packaged as funds and on the amount of those investments which are hedging unit linked and index-linked products, including information on cases where the simplified methodology (currently limited to 20% of the assets) does not cover the whole portfolio.

- Furthermore EIOPA is asked to **suggest refinements to this simplification** to cover all investments for which a simplified methodology would allow proportionate and risk-based calculations of the solvency capital requirement. Such refinements should in particular take account of the objective to **reduce the reliance on external ratings**.

Simplified approach of art.84(3) of DA

Policy options for subsequent finalisation

Article 84(3) of Regulation (EU) 2015/35 states that:

"*Where the look-through approach cannot be applied to collective investment undertakings or investments packaged as funds, the Solvency Capital Requirement may be calculated on the basis of the target underlying asset allocation of the collective investment undertaking or fund,* ***provided such a target allocation is available to the undertaking at the level of granularity necessary for calculating all relevant sub-modules and scenarios of the standard formula****, and the underlying assets are managed strictly according to this target allocation.*

For the purposes of that calculation, ***data groupings may be used****, provided they are applied in a prudent manner, and that* ***they do not apply to more than 20 % of the total value of the assets*** *of the insurance or reinsurance undertaking"*

Main comments received to the discussion paper (1)

Policy options for subsequent finalisation

Appropriateness of the 20% threshold established by Article 84(3)

- the grouping method should be allowed to be used for larger parts of asset portfolio than 20%

- consideration should be given to extending the applicability beyond unit-linked and index-linked products (and potentially beyond 20%)

- investment assets backing unit-linked and index linked products should be excluded from the look-through approach provided the market risk on those assets is negligible

- the condition of having a target asset allocation and all granular information on underlying exposures, on the sole basis of which investments are performed, is often in practice difficult to fulfil

Main comments received to the discussion paper (2)

Policy options for subsequent finalisation

Issues with the application of the simplified approach for investments which are backing unit-linked and index-linked products

- as far as the risk is supported by the policy holders, the investment related to unit-linked products could be entirely allowed for a simplified approach like a data grouping approach

- a more risk-based approach would take into account the contribution of unit-linked backing assets to the total SCR of the undertaking

- 20% threshold might be inappropriate in individual cases, especially for insurance undertakings with a strong focus on unit-linked products and therefore higher amounts of UCITs in their portfolios

Main comments received to the discussion paper (3)

Policy options for subsequent finalisation

Specific proposals to further simplify the look-through approach for investments which are backing unit-linked and index-linked products

- data-grouping may be based on the last published asset allocation and may for example aggregate equity positions or fixed-income securities in an appropriate manner

- the 30 % threshold used for reporting requirements (detailed list of assets in QRT) should apply

- need to introduce a simplified SCR calculation based on factors related to risk measure of a given investment fund (e.g. for UCITS SRRI included in the Key Investor Information Document – KIID)

Main comments received to the discussion paper (4)

Policy options for subsequent finalisation

Specific exposures for which the cost of the application of the look-through approach would be excessively burdensome

- Equity and private equity funds, because of frequent turnover of the holdings of such investment vehicles

- For unit-linked business, the application of the look-through approach, even with the given simplifications, is excessively burdensome, as the impact of unit-linked business on the SCR is negligible

- In the case of fixed income funds, it is often difficult to apply the look-through approach as key information such as rating and duration of underlying bonds is missing

- In case of "external" investment funds (managed by non-related undertakings); the information required for even a high-level estimation of SCRs is/would be very difficult to collect

Preliminary considerations on the application of Article 84(3)

Policy options for subsequent finalisation

We are aware of the cost/burden associated with the application of the look-through approach, also when the "grouping approach" of Article 84(3) is applied, but are not in favour of promoting "exemptions" or a less frequent application

We are considering the possibility to propose an amendment to article 84(3) to allow the "grouping" of exposures also when the target asset allocation *is not available at the level of granularity necessary for all relevant sub-modules and scenarios of the standard formula*

We are considering to allow "grouping" when it is applied in prudent manner (permitting to determine a conservative SCR), provided that the underlying assets are actually managed strictly according to this target allocation (or the last reported asset allocation)

We consider the arguments for increasing the threshold of article 84(3) from 20% to 30% being not convincing enough to propose an amendment

We are rather considering to promote a "carve out" from the 20% for assets covering Unit Linked/Index Linked products for which the significant part of the market risk is borne by the policy holders

Preliminary considerations on the application of a simplified look-through

Policy options for subsequent finalisation

The application of the "equity risk type 2" might be insufficient to reflect the underlying risk in some specific cases (e.g. for exposures for which the application of the look-through would determine a stress factor higher than the 49%)

We are also considering to impose an additional **qualitative condition** for the application of a **simplified look through** i.e. the assessment of the error introduced in the calculation of the SCR when the «full» look-through is not applied (applicable for both the simplified approach of art. 84(3) and the residual equity risk type 2 of article 168 (3)).

We consider this in line with the general requirements on proportionality and simplifications of the standard formula

First set of the Advice – main comments

Policy options for subsequent finalisation

Treatment of "investment related undertakings"

- if an investment mandate does not exist, other relevant indicators may be adopted, such as: i) the purpose outlined in the partnership agreement or the statute of the investment related undertaking; ii) the context of its incorporation (as investment vehicle); iii) internal investment guidelines of the (parent) insurance company

- the criteria for applying the look-through should consider whether the risk is equal to the risk in a direct investment in the underlying exposures

- Proportionality issue. Request for "optionality": non-application of the look-through when: i) the exposure is not material; ii) the SCR based on a look-through approach is lower than the SCR based on the application of equity risk

Proposed resolution: we still consider the approach currently proposed (i.e. mandatory look through) as being the most appropriate from a prudential perspective. Arguments: Homogeneous application, "look-through" is also important for purposes other than Pillar I requirements, the second set of proposals (simplified approaches) may reduce the burden for undertakings and permit better application of Article 84(3) of DA.

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Counterparty Default Risk

Table of content

Policy options for subsequent finalisation

1. Simplifications envisaged

2. Exposures to CCPs and adjustments to reflect EMIR

1. Simplifications envisaged

Policy options for subsequent finalisation

- Module where most of the simplified calculations are used
  - Around 315 in the QRTs
  - Intention to keep the optionality since it seems to work well
- Grouping of single name exposure
  - Already envisaged as an optional simplified calculation
  - Stakeholders requested clarifications as to how to perform calculations of LGD
- Calculation of the risk-mitigating effect of reinsurance arrangements
  - We update the QIS 5 formula
- Simplified calculation for risk-mitigating effect of derivatives
  - Similar to the existing one in Article 107

2. Exposures to CCPs

Policy options for subsequent finalisation

- Call for Advice: Treatment of exposures to CCP "consistent" with treatment in banking regulation

- Indirectly cleared derivatives seem only relevant exposures
- Same conditions for different treatment as in Article 305 CRR
- Treatment of indirectly cleared derivatives as type 1 exposures
- Relative consistency: Choose PD and LGD so that relation between capital requirements for bilateral and indirectly cleared exposures similar to CRR
- "Benchmark": Stand-alone bilateral transaction with "A"-rated bank
- Resulting risk charge very low
- Alternative: PD for AAA-rated exposures and recovery rate 50 % (as for reinsurance contracts)

2. Adjustments to reflect EMIR

Policy options for subsequent finalisation

- EMIR introduces obligation to exchange initial margin for large transactions and variation margin for all transactions
- Dynamic adjustments to collateral position difficult to capture as SF calculations based on assumption of instantaneous loss
- Option 1: No change
- Option 2: Adjustment, e.g. by introducing a factor x<1 in formula for LGD:

$$max\left(90\%\left(Derivative + xRM_{fin}\right) - F'(Value - xAdjustment_{market\ risk}); 0\right)$$

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Any other business?

AOB

Policy options for subsequent finalisation

- Questions on remaining topics?
- Questions on process?
- Other statements you would like to make?

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Thank you

Roundtable on the SCR review
Frankfurt, 27 September 2017