CEIOPS advice on Implementing Measures - other “3rd Wave” Consultation Papers

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Breakfast Briefing

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3rd Wave Consultation Papers

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- Lots of CPs in 3rd Wave:
  - CP 63 - Repackaged loans investments
  - CP 64 - Extension of Recovery Period
  - CP 65 - Partial Internal Models
  - CP 66 - Group Solvency for Groups with centralised risk management
  - CP 67 - Treatment of Participations
  - CP 68 - Treatment of ring-fenced Funds
  - CP 71 - Calibration of the non-life underwriting risk
  - CP 72 - Calibration of the health underwriting risk
  - CP 73 - Calibration of the MCR
  - CP 75 - Undertaking Specific Parameters for SCR
  - CP 76 - Simplifications for Technical Provisions
  - CP 77 - Simplification for SCR
  - CP 79 - Simplifications for Captives
- Plus three (CPs 69, 70 and 74) already covered in earlier presentation

Today's agenda

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- CP 73 - Calibration of the MCR
- CP 76 - Simplifications for Technical Provisions
- CP 77 - Simplification for SCR
- CP 65 - Partial Internal Models
- CP 68 - Treatment of ring-fenced Funds

CP73 – Calibration of MCR

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- CP73 builds on advice given in CP55 (Calculation of MCR)
  - **Substantial increases in MCR relative to QIS4** (in line with SCR)
- MCR should fall into a **corridor of 25% to 45% of SCR**
  - Should represent 85% VaR over 1-year time horizon
- Life MCR is a **function of technical provisions** of
  - Participating contracts, guaranteed/discretionary benefits
  - Unit-linked contracts, with/without guarantees
  - Non-participating contracts
- **With-profits floor** sets minimum MCR for with-profit contracts
- Life MCR also a **function of total capital at risk** (no longer split separately by contract term)
- **New factors derived from QIS4** results making allowance for anticipated strengthening of SCR calibration

CP73 – Calibration of MCR (life)

Selected Life MCR Factors	CP 73	QIS4
Volume measure: technical provisions		
Participating contracts, floor	2.5%	1.5%
Unit-linked contracts, without guarantees	0.8%	0.5%-1.75%
Unit-linked contracts, with guarantees	2.8%	0.5%-1.75%
Non-participating contracts	3.2%	1.0%-3.5%
Volume measure: capital at risk		
Total capital at risk	0.14%	0.05%-0.13%
Volume measure: administrative expenses		
Administrative expenses	Nil	25%

CP76 – Simplifications for TPs

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- CP76 sets out CEIOPS's latest advice on the use of **simplified methods** to calculate **technical provisions**
  - Follows on from three "2^{nd} Wave" papers – CP39, CP43 and CP45
- CEIOPS advice:
  - **Methods should be proportionate** to the nature, scale and complexity of the risks and suited to the specific characteristics of the risks
- CP76 proposes a **three-step proportionality assessment**
  - Qualitative assessment of nature, scale and complexity of risks
  - Assess suitability of chosen method having regard to materiality of model error
  - Back-test against historic and emerging experience
- Also **suggests possible simplifications** for various risks
- **Useful option for smaller companies** – but will require testing/justification & dialogue with Regulator

CP77 – Simplifications for SCR

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- CP77 sets out CEIOPS's latest advice on the use of **simplified methods** to calculate the **SCR**
  - Follows on from CP45
- CP77 proposes a **two-step proportionality assessment**
  - Same as first two for CP76, but no back-testing required here
- List of simplifications
  - **Some unchanged from QIS4**: Counterparty default risk, life catastrophe risk, lapse risk , revision risk
  - **Some changed from QIS4**: Credit spread risk on bonds, mortality, longevity, disability/morbidity, expenses
- **Some simplifications removed**
  - Interest rate risk, equity risk, credit spread risk for derivatives and structured products, loss absorbing effect of profit sharing
- Application criteria/restrictions
  - No approval process; can only use if Standard would be "undue burden"

CP65 – Partial Internal Models

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- **Scope of PIMs**
  - Module, sub-module, business unit, operational risk, adjustment, risks not covered in standard formula

- **Major business unit**
  - Managed with independence and dedicated governance processes
  - Makes sense to calculate profit and losses
  - Makes sense to calculate capital charge

- **Specific provisions for approval**
  - Justify limited scope
  - Better reflection of risk profile
  - Integration with standard formula possible
  - Transitional plan may not be required if conditions met

CP65 – Partial Internal Models

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- **Integration of PIMs**
  - Examining options where standard formula not possible/feasible
  - Step 1: Standard formula correlation matrix if possible & feasible
  - Step 2: Techniques to be provided by CEIOPS in level 3
  - Step 3: Other techniques if none of the above possible/feasible
  - Step 4: Supervisor decides

- **Adaptation of articles**
  - Changes to Use Test, calibration, validation etc.

- **Risks not covered by standard formula – options**
  - Assume linked to existing risks
  - Establish new risk module
  - Assume linked to specific business unit and full model for this unit

CP68 – Ring-fenced Funds

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- Paper sets out two alternative **definitions of RFFs**
- **Alternative A**
  - Going concern basis
  - RFF defined as arrangement where there is a barrier to the sharing of profits/losses arising from different parts of the business and/or own funds can only be used to cover losses on a defined portion of the company's business.
- **Alternative B**
  - Winding-up basis
  - Narrower definition of RFF - RFF must be legally or contractually separated from the remainder of the entity.

- Seems like "with-profits" funds fall under Alternative A whereas PCCs and closed funds (e.g. post-demutualisation) fall under B.

CP68 – Ring-fenced Funds

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- **Treatment of RFFs** differs from QIS4 approach
  - Not surprising as QIS4 approach had been flagged as preliminary
- **Company-level SCR calc:**
  - Principle: Adjust for those risks where a barrier to the sharing of profits/losses exists.
  - Calculate capital charges for such risks at the level of the RFF
  - Add up total capital charge for each RFF plus total capital charge for all business/risks outside of RFFs.
- **Eligible own funds calc:**
  - Own funds calc should exclude:
  - (a) the surplus in any RFF over the notional SCR for the RFF, where such surplus cannot be used to cover risks outside the RFF; and,
  - (b) any diversification benefits between the RFF and other funds.

Summary

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- **CP 73 - Calibration of the MCR**
  – Increase in factors linked to increase in SCR calibrations
- **CP 76 - Simplifications for Technical Provisions**
  – Simplifications allowed if 3-step proportionality test is met
- **CP 77 - Simplification for SCR**
  – Some changes to simplifications from QIS4
  – Also some QIS4 simplifications now disallowed
- **CP 65 - Partial Internal Models**
  – Justification for and integration of Partial Internal Models
- **CP 68 - Treatment of ring-fenced Funds**
  – Two types; Impact on company-level SCR and Own Funds calcs