insurance europe

Position Paper

Response to EIOPA consultation paper on the revision of the guidelines on the valuation of technical provisions

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Introduction

1. General comments
   - The consultation paper suggests that the European Insurance and Occupational Pensions Authority (EIOPA) already intends to apply the revised guidelines in 2022 (see paragraph 1.18) and that currently no **transitional phase** is foreseen. For undertakings that have not already implemented the details of the revised guidelines, a sufficient **transitional period, eg at least three years**, is required. As all relevant resources are currently bound to the implementation of International Financial Reporting Standards (IFRS) 17 — insurance contracts , an even a longer transitional period would be welcomed, in order not to jeopardize the timely implementation of IFRS 17.
   - Proposals introduced throughout the paper **increase the granularity of the calculations required** (eg regarding, dynamic policyholder behaviour, option to pay additional or different premiums, changes in expenses, use of stochastic valuation, market risk factors). And, although they all **aim to improve the calculation results** via labour-intensive fine-tuning, the effective enhancement is expected to be very limited in practice. At the same time, the burden of proof for non-materiality of the amendments is solely on insurance undertakings. Before introducing such amendments, a sufficient demonstration that the impact is material should be conducted.
   - Some proposals could even force undertakings to apply unrealistic management actions which would result in **distorted results**: for example, guideline 40b on the consideration of new business in setting future management actions.
   - Additionally, it should be verified beforehand that a close causal relation can be captured in figures at all. Indeed, the amended guidelines imply that it is up to expert judgment to estimate missing data, even though there might not always be sufficient data to prove a causal link. It is difficult to rebut assumed relations in such a case, especially as policyholders can not be assumed to always act rationally.
   - Proportionality should be explicitly referenced throughout the guidelines.

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Guidelines

Expert judgement

2. **Guideline 24a (NEW) - Materiality in assumptions setting**

- The industry recognises the need to assess the materiality of assumptions/expert judgement. This assessment could, for example, mean a sensitivity on the range of possible settings of an assumption. This is already reflected in the Solvency II Regulation, notably in the description of the role of actuarial function in Article 272(5), which requires a reasoned analysis of the reliability and adequacy of the technical provision (TP) calculation, and on the sources and the degree of uncertainty of the estimate of the TPs, supported by a sensitivity analysis, as appropriate.
- However, the internal model guidelines in respect of expert judgement, on which the proposed guidelines (24a to 24e) are based, are in the context of insurers setting their capital requirements in extreme scenarios. It is not proportionate to bring in the same requirements for expert judgements in the context of best estimate assumptions. For example, it does not seem proportionate to perform this sensitivity analysis for scenarios which are only with negligible weight included in the best estimate calculation. **Proportionality should be recognised in any new requirements for expert judgements**, by reducing the extent of work and documentation, and it should not be assumed that internal model expert judgement requirements are appropriate across the board for all companies/expert judgements.

Biometric risk factors

7. **Guideline 25 (AMENDED) - Modelling biometric risk factors**

- In paragraph 2.21, it is stated that "*Undertakings should ensure, when assessing whether a method that assumes that biometric risk factors are independent from any other variable is proportionate, and that the specificities of the risk factors are taken into account. For this purpose, the assessment of the level of correlation should be based on historical data and expert judgment.*"
- In fact, in most cases there is no evidence that mortality, longevity, disability are correlated with economic factors such as interest rates, credit spread and equity prices. The requirement of independency in all cases implies an unnecessary burden.
- The proof that biometric risks are independent of any other variable should not be required rather, only in case the undertaking deems — in some rare circumstances — the existence of correlation, the proof of dependency shall be supplied before running technical provisions using stochastic biometric assumptions.

Expense allocation

8. **Guideline 28a (NEW) - Investment management expenses**

- **Proposal to include investment expenses (IM) backing the SCR**
  - It is proposed that IM should be taken into account in the TP calculation in respect of TP and the solvency capital requirement (SCR). The SCR and the risk margin (RM) should not be included, as only the assets backing the best estimate (BE) are relevant here, as per policy option 3.4.
  - For **not including IM expenses backing the RM:**
    - The BE shall take account of all the cash in- and out-flows required to settle the (re)insurance obligations (Article 77(2)). As the RM does not represent a cash flow to settle the obligations, it should not be considered as part of this calculation.
    - The other (reference) undertaking would have to hold assets on top of the TP to cover the SCR of that other insurance undertaking (Article 38(2)). The cost for the other insurance undertaking of obtaining and holding the SCR is captured in the RM (Article 77(4) and (5)).

- Furthermore, Article 77(4) indicates that the BE and RM are determined by separate calculations, which implies no interdependency of investment expenses backing RM and BE projections.
- If it were the intention of the legislator to include IM on assets backing the SCR, this would have been explicit in Article 78 and/or Article 31; changes in these articles should have been part of the 2020 Review.
- Article 77 is positioning the TP to be the sum of a BE and a RM. Article 77 (5) — assuming the separate valuation of RM and BE represents the base case — states for the RM "*the RM shall be calculated by determining the cost of providing an amount of eligible own funds equal to the SCR necessary to support the insurance and reinsurance obligations over the lifetime thereof*". It should therefore by definition be noted that the RM is already representing a cost to hold capital. Introducing (unjustified) additional costs in the BE would be double counting which the industry opposes.

- Including RM and SCR in the calculation of the BE can only be implemented approximately due to the circular reference with TP. Corresponding simplifications are necessary in any case which would have to be developed and tested.

- **Reimbursements of IM (kickbacks) shown as other incoming cash flows**: Undertakings that currently consider kickbacks as cost reduction will have to restructure the calculation model in order to calculate and show them as other cash inflow (see paragraph 2.23) in the annual reporting template. The changes in the calculation model will need proper time for testing and implementation.

10. **Guideline 33 (AMENDED) - Changes in expenses**
    - The implementation of the amendment and the implications from the corresponding explanatory text concerning **inflation** require a remodelling of the calculation program. **Correlations between inflation and interest rates** are not yet available and have to be developed first. Once adequate correlations are on hand, they have to be integrated in the calculation model. This again will need proper time for testing and implementation.
    - The interaction between expense's inflation and other policy flows should be further explained. On the other hand, the mention in the explanatory text of the use of different levels of inflation per type of expense is highly complex to implement in practice. It should either not be mentioned at all, or be mentioned in lighter or generic terms. Additionally it should be mentioned that there are expenses which may not be affected by inflation (eg commissions with a calculation already stipulated and subject to contractual conditions).

Treatment of financial guarantees and contractual options

11. **Guideline 37a (NEW) - Dynamic policyholder behaviour**
    - The new guideline seems to increase the expectation of having to include dynamic policyholder behaviour or to expand the proof that dynamic policyholder behaviour is immaterial.
      If the assessment leads to the conclusion that dynamic policyholder behaviour must be considered from now on, this must be developed first. This will require additional data and a remodelling of the calculation program, as well as extensive testing.
    - It should be noted that even in the Covid-19 pandemic, the observed policyholder behaviour was relatively stable.
    - From the industry's perspective, it is expected that this will result in a high degree of additional effort for a limited effect. The consideration of the possible interaction (as suggested by the explanatory text) between surrender level, the contract return and the return on the market will be especially burdensome to develop.

13. **Guideline 37c (NEW) - Option to pay additional or different premiums**
    - The modelling of contractual options that might have not been considered relevant until now, will need time for implementation. Again this would require additional data, a remodelling of the calculation program, as well as extensive testing.
    - In particular, the consideration of indation would increase the required input data dramatically.

- Furthermore, the proof of immateriality of such a contract option would have to be expanded, as the new guideline increases the expectations regarding consideration of the contractual option.

Future management actions

15. **Guideline 40b (NEW) - Consideration of new business in setting future management actions**
    - The example in the explanatory text of paragraph 3.23 indicates that the assumptions on management actions for new investments should consider the new business assumptions. However, in the projection for best estimate calculation, only the run-off of the current existing portfolio is projected. The investment decisions in the model would, therefore, no longer be aligned to the portfolio considered. The industry does not consider this to be a reasonable requirement.
    - In para 2.32 EIOPA states that *"in particular, the application of contract boundaries should not influence such assumptions [future management actions], for example regarding asset allocation, bond reinvestment or profit sharing*."
        - In the case of the application of contract contract boundaries, it is unlikely that the premium or the option will be accepted or granted by the insurer without reflecting on the investment risks which will arise when the premium is due or the option is requested by the customer.
        - In other cases, the contract boundary is applicable because there is no financial risk with discernible effect, even in extreme scenarios. Therefore, the need to pay attention — within the set of management actions — on asset allocation, bond reinvestment or profit sharing linked to premiums and options that meet contract boundary is not consistent with the features justifying the contract boundary itself.

Methodologies for the valuation of contractual options and financial guarantees

16. **Guideline 53a (NEW) - Use of stochastic valuation**
    - The new guideline increases the pressure on undertakings to apply stochastic valuation in additional line of business /homogenous risk groups (LoBs/HRGs) or to expand the proof that the options and guarantees are not material and therefore stochastic valuation is not appropriate. The implementation of stochastic valuation in additional LoBs/HRGs would require additional data, a remodelling of the calculation program, as well as extensive testing.
    - The new guideline, which is a clarification of the current guideline 53, encompasses <u>all</u> products with profit-sharing and financial guarantees (which means nearly all life insurance saving products apart from unit-linked). As a result, the new scope will be much broader than is currently the case. Furthermore, it is noted that, as opposed to the current guideline 53, no proportionality is foreseen in the new guideline, even though dynamic lapse modelling requires a lot of work.
    - Against this background, the industry opposes the broadening the scope, and would ask that proportionality is foreseen.
    - Based on the explanatory text in paragraphs 3.24-3.26, it can be assumed that stochastic valuation avoids underestimation of provisions. From this perspective, the industry would ask for the possibility of maintaining non-stochastic criteria and models, as long as it can be demonstrated that they are more prudent.
    - For example, when performing a stochastic valuation on future interest rate renewals for products with a variable rate, a margin above the guaranteed rate could be included in all scenarios according to the policy conditions. In this case, a simplified criteria in which these margins are not projected, could be more prudent.

Economic Scenario Generator

17. **Guideline 57a (NEW) - Market risk factors needed to deliver appropriate results**
    - In paragraph 2.36, the explicit requirement to consider the dependence on spread or default risk should be deleted. On the one hand, the requirement is in general already implied in the delegated acts; on the other hand, it is not clear why each undertaking should perform this assessment.

- An integration of credit/spread risk modelling in best estimate valuation is very burdensome: the economic scenario generator will have to be amended and, in addition, a proper and robust procedure for calibration would need to be implemented and the corresponding data procured. Apart from that, the asset model, which is a part of the overall valuation model, must be refined. As a consequence, additional expertise needs to be built up.
- Against this background, industry would ask EIOPA not to introduce new general requirements via this explicit guideline.

Expected Profits In Future Premiums ("EPIFP")

18. **Guideline 77 (AMENDED) - Assumptions used to calculate EPIFP**
    - There is no requirement under Article 272, which describes the tasks of the actuarial function, for the actuarial function to validate the expected profit in future premiums (EPIFP) calculation. The wording here should be amended to reflect that "if the actuarial function validates the EPIFP, this should be done with specific reference to…".
    - Furthermore, the amendment in paragraph 2.38 and the corresponding explanatory text assume that a certain structure of expenses is already implemented in the calculation model. Undertakings that do not differentiate between fixed and variable costs, will not be able to implement the amendment fully. They would therefore be either forced to restructure the modelling of the costs or companies would have to prove that they apply an appropriate simplification (and the acceptance always depends on the view of the auditor or competent supervisory authority). Therefore, the pressure is increased to adapt the calculation model and to implement the structure of expenses referred to by EIOPA in the explanatory text.
    - Para 2.38: [Assumptions used to calculate EPIFP] "*All the other assumptions….should remain unchanged. This means that the undertakings should apply the same projection horizon, future management actions….*"

      The industry asks EIOPA to provide some more background on guideline 77. For example, maintaining the same management actions in the valuation of TP without RM, under the assumption that premiums expected to be received in the future are not received, could imply a change in the future returns of the underlying assets and hence the liability for future discretionary benefits and the cost of financial guarantees of business with discretionary participating features.

Explanatory text

Methodologies for the valuation of contractual options and financial guarantees

28. Explanatory text on guideline 53a (NEW) - Use of stochastic valuation
    - There may be cases where the reasoning of the explanatory text for 3.26 is not completely correct. For example, in cases where clients can surrender at market value, the rationale for client behaviour in high or low rate environments is not accurate.

Section 4.4. Policy Options

33. Section 4.4.1. Policy issue 1: Introduction of additional guidelines vs status quo
    - The mention in the explanatory text of the use of different levels of inflation per type of expense is highly complex to implement in practice, EIOPA should remain more generic/high-level in its wording, or remove it.