Solvency II – Position on the calculation of the Solvency Capital Requirement (SCR)

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The European Association of Paritarian Institutions – AEIP, founded in 1996, is a Brussels-based advocacy organization, representing Social Protection Institutions established and managed by employers and trade unions on a joint basis within the framework of collective agreements.

In the context of social protection, paritarism is a type of self-organization of social relationships which on the basis of equal negotiations, brings about agreements which are equally binding on both employers and employees. This kind of self-organization goes from the paritarism of negotiation to the paritarism of management and results in various types of agreements, from adhesion to a particular form of cover to the creation of a paritarian institution.

The Association has 20 Associate and Affiliate members - all leading large and medium-sized Social Protection Institutions, from 12 European countries, as well as 13 Task Force Members from 3 European countries. All AEIP members are not-for-profit organizations.

In particular, AEIP deals – through dedicated working groups – with EU coordinated pension schemes, pension funds, healthcare, unemployment and provident schemes, paid holiday and health & safety at work schemes. Complementary to their role as non-for-profit social protection providers, AEIP members are also long-term institutional investors.

AEIP represents its members' values and interests at the level of both European and international institutions.

For more information: www.aeip.net

Current state

The Solvency II Directive came into force as of 1st of January 2016 and is currently the subject of a review process, carried out by EIOPA on the request from the European Commission (EC), focusing on certain aspects of its quantitative pillar. The recommendations made by EIOPA in its final report from 28 February 2018 could be taken into account by the EC in the process of updating the Solvency II Delegated Regulation that will come into force in 2019.

In this context, what is the position of the healthcare paritarian insurers (IPs)? Which first assessments can we make after two years of implementation?

With regard to Solvency II and its quantitative pillar, the principle of calculation of the solvency margin based on risks was a provision welcomed by the entire sector. **However, there remains the need for improvement in several directions that the European Association of Paritarian Institutions (AEIP) would like to promote. Those concern particularly the treatment of occupational retirement in Solvency II, the option of an expanding USP to life risks as mortality and longevity risks and removing the proposal for increase the shock on the relevant risk-free interest rate term structure.**

1 - Health and income protection, reasonably calibrated “shocks”…

Under Solvency II, the impact of a loss (excluding catastrophic events) is measured in percentage (“shock”) of technical provisions (for claims already occurred) and of premium volume for the future loss (with the risk that premiums are not enough to cover future loss). This corresponds to the "underwriting risk" under Solvency II.

The “shock” applicable to health medical expense (HME) risk was, with four other risks (credit, assistance, and legal protection and workers compensation) one of the calibrations under review within the framework of the Solvency II revision for 2018.

EIOPA’s proposal to maintain the “shock” on HME premiums at 5% is supported by AEIP, as we consider this level of calibration to correspond to the risk observed on the European market.

...but an excessive premium volume

If the underwriting risk for health medical expense appears to be properly calibrated with respect to the applied shocks, the definition of the premium volume to which it applies is based on an ambiguous regulation text which could lead to inconsistencies, as according to EIOPA’s interpretation - the addition of two months to next year’s 12 months of premiums. Indeed, we notice that this ambiguity leads to different interpretations at the level of the individual Member States.

In the case of annual contracts with tacit renewal, the calculation based on fourteen months instead of twelve will cause a loss to the amount of 5 basis points on average to SCR ratio of AEIP members.

AEIP regrets this conservative position, included in EIOPA's proposals, that does not resolve differences in treatment between Member States and does not remove the ambiguity of the form of calculation.

2 - More important shocks on interest rate curves

The calculation of the SCR implies the test of the impact of a sharp increase or decrease of rates on the insurance undertaking's solvency. As the calibration of the interest rate risk in the standard formula, lower actual market rates are associated with weaker shocks. While the revision of the shocks on the relevant risk-free interest rate term structure was not initially part of the subjects recommended by the European Commission, EIOPA decided to review this mechanism.

EIOPA proposes to make shocks harder by introducing a fixed component to the proportional shock: in the case of an increase, the shock would be between 50% and 100% greater. In the case of a decrease, it would be greater as well, according to the maturity and could even reach negative values. As the impact of this change in methodology is significant, especially on the downward shock (EIOPA estimates a loss of 14 points on average on the SCR coverage ratio), EIOPA proposes to allow for an adjustment period of over 3 years.

Obviously, in the current low interest rate environment, the downward shock foreseen in Solvency II is reduced. Still, the two years of decline that we are currently experiencing show that all mechanisms foreseen in Solvency II that measure risks worked well despite the market volatility, allowing to calculate a solvency capital requirement in consistency with the interest rate risk. **Therefore, AEIP does not consider that there is urgency for modifying the calibration of the SCR in the standard formula**.

Moreover, when proposing to change a calibration, as it is the case in EIOPA's proposal, negative consequences of such changes must also be taken into consideration. In this case, making calibration tougher as proposed by EIOPA will have negative effects on long-term investments although the financing needs of the economy remain crucial for the Member States that are part of the Euro area.

Finally, AEIP stresses that there are other levers available to insurance supervisors and undertakings to capture the evolution of the relevant risk-free interest rate term structure: the ORSA and stress tests are two examples that would allow supervisors' concerns to be addressed effectively without having to increase shocks on the relevant risk-free interest rate term structure.

3 - The use of undertaking-specific parameters (USP) should be extended

Solvency II provides the opportunity for insurance undertakings that wish to use their own data (USP) to define their standard formula's calculation parameters in order to have a more accurate Solvency Capital measure consistent with the specifics of their risk. Currently, this option only applies to underwriting risk (premiums and provisions), which excludes the use for life risks like mortality and longevity risks.

Measure of the drop in mortality and longevity risk, as it appears from Solvency II's current parameters, can on certain occasions not correspond to the reality of risk borne by undertakings.

For this reason, AEIP regrets that EIOPA expressed an opposition to any evolution towards an opening of the use of USPs in its response to the EC within the framework of the 2018 review of Solvency II and calls for an introduction of the use of USPs for these risks. We consider that this would provide for resolving specific cases without having to modify the standard formula.

4 - Risk margin calculation has not evolved since 2012, while we are in a context of falling interest rates

The assessment of the risk margin is based on a "cost of capital" (CoC) approach, in other words it is defined as the present value of (solvency) cost of capital over a given period. It is in fact the price that an insurance undertaking (as an investor) would be ready to pay in order to take over insurance obligations and to cover the payments for the full duration of the liabilities.

The rate used to determine the current value of capital was set by EIOPA at 6% in 2012. It has not changed since then and EIOPA proposes to maintain it as it corresponds to the minimum return that an insurance company would have to pay to its capital investors.

However, market rates have continually decreased since 2012 (at the end of 2011, the EURIBOR 1st year was 1,9% while it finished 2017 at -0,188%), which means that the solvency cost of capital is much lower today than it was in 2012.

AEIP regrets EIOPA's proposal to maintain the 6% rate for the calculation of the margin risk, especially because a downward revision of this rate would be consistent with EIOPA's decision to lower in 2018 the ultimate forward rate (UFR) that allows to update the long-term commitments like occupational retirement.

5 - Occupational retirement, an activity that Solvency II fails to adequately address

Insurance undertakings and European pension funds are both significant providers of occupational pensions while they are subject to significantly different regulatory regimes. Insurers are required to comply with Solvency II, while pension funds are regulated under the IORP II Directive.

The highly volatile nature of the calculation of the Solvency II Capital Requirement, under volatile market conditions remains fully relevant in the case of very long-term commitments like occupational retirement schemes. This volatile SCR introduces short term behavior which is in contradiction with the long term nature of the pension liabilities and which has a negative impact on the long term returns on pension funding. AEIP remains convinced that long term nature of pension liabilities needs to be taken into account within the Solvency II framework. This is also important, seen the European Commission's ambition with regard to sustainable and long term finance of the European economy.

It is for these reasons that AEIP stresses on the need for a specific module on occupational retirement activities integrated in Solvency II. Such a module would allow Solvency II to propose an appropriate approach for the calculation of the Solvency Capital Requirement, taking into account very long-term commitments, like those of occupational retirement.

AEIP is ready to provide its expertise and input in the following steps on this dossier.