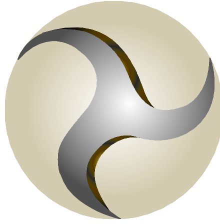

ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

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Consultation Response

Insurance (Long-Term Business Valuation and Solvency) Regulations 2021

CR21-06

Issue Date: 25 June 2021

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Glossary

Authorised long term business insurer	An insurer authorised under section 8 of the Insurance Act 2008 to carry on class 1 and 2 insurance business
Authority	Isle of Man Financial Services Authority
Cell	Cellular part of a PCC
Core	Non-cellular part of a PCC
IC	Incorporated Cell of an ICC
ICC	Incorporated Cell Company
IAIS	International Association of Insurance Supervisors
ICPs	Insurance Core Principles (of the IAIS)
MCR	Minimum Capital Requirement
PCC	Protected Cell Company
QIS	Quantitative Impact Study
SCR	Solvency Capital Requirement

1. Background

This Feedback Statement is issued by the Isle of Man Financial Services Authority following Consultation Paper CP21-01[1].

The purpose of the consultation was to seek views on the proposed update of the Insurance (Long-Term Business Valuation and Solvency) Regulations 2018 to reflect the provisions of the proposed Insurance Regulations 2021 and for consistency with the Insurance (Non Long-Term Business Valuation and Solvency) Regulations 2021, as well as to expand the requirements to cover Protected Cell Companies and Incorporated Cell Companies.

2. Summary of Responses

We received six responses which found the proposed amendments to be reasonable.

Two responses included suggested changes to the technical calculations underlying the SCR. The Authority intends to carry out a review of the SCR calibration following the completion of EIOPA's Solvency II 2020 review and the subsequent publishing of their legislation to ensure consistency where appropriate. This is in line with the Authority's stated intent to develop a risk based capital regime for life insurers that could obtain Solvency II equivalence. These comments will be considered as part of that review.

The Authority has considered the matters raised and a summary of the responses to the consultation feedback can be found in the appendix.

3. Changes to the Proposals

Implementation Date

The consultation paper stated that the Regulations were due to be implemented on 30 June 2021, alongside the new Insurance Regulations 2021 to which they are related.

The implementation of the Insurance Regulations 2021 has been deferred to around 31 December 2021 to provide the Authority with time to complete the discussions surrounding the definition of a class 12 insurer with the captive insurance industry, as well as to provide sufficient time for non-life insurers to prepare to comply with the new regulations. Hence the implementation of the Insurance (Long-Term Business Valuation and Solvency) Regulations 2021 has also been deferred to around 31 December 2021.

Composite SCR:

Feedback was received on the Authority's proposed approach to determining a consolidated SCR for the Island's only insurer authorised to sell both long-term and non-long term business.

[1] https://consult.gov.im/financial-services-authority/long-term-business-valuation-and-solvency-regs2021/

Initially the Authority had proposed under regulation 33 that there would be no allowance for diversification between the non-life underwriting risk SCR and the other risk modules (i.e. market risk, counterparty default risk, life underwriting risk etc.).

In light of the feedback received, the Authority has reconsidered this approach and has determined it is appropriate to allow for diversification between non-life underwriting risk and the other risk modules. The correlation has been determined in accordance with the approach adopted by EIOPA in Solvency II.

As such regulation 28(5) and (6), Solvency Capital Requirement, has been updated to reflect this change as follows:

(5) The standard formula approach used to determine an insurer's SCR is the sum of —

(a) *its SCR determined using the standard formula approach in paragraph (6); and*

(b) *any adjustment as may be specified by the Authority as a capital add-on under regulation 29.*

(6) The insurer's SCR using the standard formula approach is —

$$SCR = \sqrt{BSCR^2 + BSCR \cdot SCR_{op_UL} + SCR_{op_UL}^2} + Adj + SCR_{op_{nonUL}} + SCR_{op_{non-life}}$$

where—

(c) *BSCR is determined under regulation 33;*

(d) *Adj is determined under regulation 35;*

(e) *SCR_{op_UL} and SCR_{op_nonUL} are determined under regulation 37; and*

(f) *$SCR_{op_non\text{-}life}$ is the non long-term business operational risk SCR determined under the Insurance (Non Long-Term Business Valuation and Solvency) Regulations 2021 (applicable only for insurers who are also authorised to write classes 3 to 9 insurance business)*

Regulation 33 has also been amended as follows:

(2) *The BSCR includes capital requirements for the following risks—*

(a) *market risk;*

(b) *counterparty default risk;*

(c) *life underwriting risk;*

(d) *health underwriting risk;*

(e) *non-life underwriting risk (applicable only for insurers who are also authorised to write classes 3 to 9 insurance business); and*

(f) *intangible asset risk.*

(3) *An insurer's BSCR is determined as follows—*

$$BSCR = \sqrt{\sum_{r,c} Corr_{r,c} \cdot SCR_r \cdot SCR_c} + SCR_{intangibles}$$

where—

(g) *$Corr_{r,c}$ are the entries of the correlation matrix Corr;*

(h) *SCR_r and SCR_c are the capital requirements for the individual SCR risks according to the rows and columns of the correlation matrix Corr;*

(i) *$SCR_{intangibles}$ is the capital requirement for intangible asset risk;*

(j) *Corr is defined as—*

Corr	***Market***	***Default***	***Life***	***Health***	***Non-life***
Market	*1*	*0.25*	*0.25*	*0.25*	*0.25*
Default	*0.25*	*1*	*0.25*	*0.25*	*0.5*
Life	*0.25*	*0.25*	*1*	*0.25*	*0*
Health	*0.25*	*0.25*	*0.25*	*1*	*0*
Non-life	*0.25*	*0.5*	*0*	*0*	*1*

(6) *The capital requirement for non-life underwriting risk in paragraph (2)(e)is determined under the Insurance (Non Long-Term Business Valuation and Solvency) Regulations 2021.*

Regulation 95 NSLT health lapse risk capital requirement

The wording of regulation 95 (NSLT health lapse risk capital requirement) has been amended to be consistent with the NSLT health lapse risk capital requirement under the Insurance (Non Long-Term Business Valuation and Solvency) Regulations 2021. The new wording is:

(1) *Under regulation 91(1)(b), an insurer's capital requirement for NSLT health lapse risk, is the insurer's loss in basic own-funds following an instantaneous permanent decrease in the profit anticipated from future insurance contracts .*

(2) *The decrease to be applied is 40%.*

(3) *When determining the capital requirement, an insurer's contracts can be grouped as long as within each grouping profitable contracts are not offset by unprofitable ones.*

Reinsurance as a risk mitigation

Following several recent requests, the Authority, has deemed it necessary to include additional clarifications within regulation 101 (Qualitative criteria for risk mitigation

techniques) to assist insurers who wish to use risk mitigation arrangements, such as reinsuring certain risks within the SCR, for capital optimisation purposes. As such regulation 101 has been amended with the following paragraphs added:

> *(5) Under paragraph (1)(a), an insurer must prove the extent of an effective transfer of risk in order to ensure that any reduction in SCR or increase in own-funds resulting from its risk transfer arrangements is commensurate with the change in risk that the insurer is exposed to.*
>
> *(6) Further to paragraph (5), an insurer's SCR and own-funds must reflect the economic substance of the risk mitigation arrangement that implement the risk transfer, in particular, when calculating the BSCR under regulation 33, an insurer must only take into account a risk mitigation technique where —*
>
> (a) *the reduction in SCR, or increase in own-funds, is commensurate with the extent of risk transfer; and*
>
> (b) *there is an appropriate treatment within the SCR of any corresponding risks that are acquired as a consequence of implementing the risk mitigation technique.*

4. Next Steps

The Authority will proceed to make the Insurance (Long-Term Business Valuation and Solvency) Regulations 2021 for implementation around 31 December 2021.

In case of any query, please contact —

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Appendix – Table of responses

General Feedback	Comment received	Our response
1	'…These proposals will have minimum impact on our business from a Solvency perspective and we will be able to implement these updates in methodology if required for the June 2021 implementation date.'	Thank you for your response.
2	'The licenced entities within the XYZ group have reviewed the proposed changes and have no comments'.	Thank you for your response.
	'Firm XYZ has no comments to make in respect of the proposed changes as currently drafted.	Thank you for your response.
3	Regulation 9 changes – it would be good to clearly specify methodologies accepted when valuing non-conventional assets e.g. inter-company loan holdings. Clarification on whether Book cost vs assessed market value on a discounted basis would be useful. Please confirm if you need to see the expense adjustments in a separate paper as firm XYZ currently allows for expense changes expected to occur due to a Mass lapse event. We can share the Mass Lapse methodology paper as part of the annual submissions. The question we have is around the treatment of PCCs and ICCs for purposes of participation in the Policyholder Compensation Scheme. One reason for high net worth individuals/families for setting up a private life company would be disaggregation effect i.e. not expecting their assets mixed with other policyholder assets. In turn, they would be expecting to carry all the risks of failure but	Thank you for your response. We do not intend to codify this in regulation at this time, as each non-conventional asset may have different considerations. We advise insurers to discuss any concerns they have with valuing assets of this type with their auditors in the first instance. Any expense adjustments made should be clearly communicated to the Board via the actuary's report or appended methodology paper. This will be considered as part of the Policyholder Protection Scheme review that is currently on going.

	potentially not expecting to be part of the wider protection scheme. Thoughts on this would be welcome.	
4	Firm XYZ considers that the relationship between lapse risk and expense risk within the Isle of Man solvency framework should be reviewed to better reflect the dependency relationship between these two risks. In particular, this relates to the treatment of expense diseconomies of scale under a mass lapse stress. The current solvency rules and guidelines have the expense diseconomies of scale captured through two separate components of the capital requirement calculation (refer to component 1 and 2 below). Firm XYZ considers that this constitutes a potential double counting of losses within the capital requirement. **Component 1** - The expense diseconomies of scale arising from the mass lapse stress is captured through the correlation factor of 0.5 between the lapse risk and the expense risk This interpretation is supported by the CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR STANDARD FORMULA Article 111(d) Correlations (CEIOPS-DOC-70/10 dated on 29 January 2010). This document states: *Expense risk*	Thank you for your response. As you are aware the Authority's SCR calibration is taken from EIOPA's Solvency II regime. These suggestions will be considered as part of the future planned review of the SCR Calibration, following the completion of EIOPA's Solvency II review 2020.

	3.82. Some insurance events like lapse, disability and revision can lead to additional expenses for the undertaking. For example, in case of a mass lapse event the number of transactions increases drastically, and the internal processes of the undertaking would need to be adjusted accordingly. Moreover, ***a revision of the economies for scale in relation to the future expenses would need to be made****. In case of an increased probability of disability events or annuity revisions, the expenses for the assessment and management of these events will rise.* *3.83.* ***In order to allow for this causal connection****, similar to QIS4,* ***a medium correlation factor of 0.5 for lapse****, disability and revision* ***risk in relation to expense risk seems to be appropriate****.* We have not seen a similar calibration document for the correlation factors used for the Isle of Man solvency assessment. However it is difficult to rationalise the need of having a strong correlation factor of 0.5 between the expense risk and the lapse risk if it is not for capturing the diseconomy of scale relationship. Moreover, the industry survey of the UK internal model firms shows that that these firms on average have less than 0.15 correlation factor between expenses and mass lapse risk. Presumably these internal model firms capture the diseconomy of scale within the mass lapse	

	risk. This demonstrates that the intension of having the 0.5 correlation factor within the current solvency rules is to capture the economies of scale relationship between the lapse risk and the expense risk. <u>**Component 2** - The expense diseconomies of scale is captured within the standalone mass lapse stress</u> This is supported by EIOPA Q&A response to Q&A number 1678), published on 22 November 2018. EIOPA Q&A number 1678 is as follows: *Question: When calculating the capital requirement for Mass Lapse risk should the per-policy expenses remain unchanged, resulting in the overall expenses falling proportionally?* *EIOPA answer: The capital requirement for mass lapse risk in accordance with Article 142(6) of Commission Delegated Regulation (EU) 2015/35 should reflect the adjustments after the mass lapse event that the insurer would have to make to the expense component of the cash flow projection in the best estimate calculation. Whether and by how much future expenses can be reduced due to the lower number of policies depends on company specifics like the proportion of fixed and variable costs.* ***Using the assumption of constant per policy***	

	expense for determining the capital requirement for mass lapse risk may in many cases be too optimistic with respect to the possibility to reduce costs. These two components lead to differing market practice amongst insurance firms in scope of solvency II. Since lapse and expense risks are typically material risks within the SCR, the treatment of the relationship between these risks has the potential to have a material impact on the SCR. We propose the Isle of Man FSA to review the proposed changes in Long Term Business Valuation and Solvency Regulations to avoid double counting of losses when assessing the diseconomy of scale relationship between the expense and lapse risk of the capital requirement calculation. The review should cover: • the treatment of the expense diseconomies of scale under a mass lapse stress; and • the correlation factor between lapse risk and expense risk. To achieve a compromise between the two components discussed early, one potential methodology to deal with the loss of economy of scale is for firms to assess the extent of the impact of loss of economy of scale under mass lapse that is already captured in the prescribed formula through the relatively strong correlation factor of 0.5 between the lapse risk and the expense risk. Any residue loss of	

	economy of scale is then included within the standalone mass lapse capital requirement. This treatment would also be consistent with the XYZ Group methodology for mass lapse under the PRA / EIOPA rules.	
5	*[in relation to the consolidation of the life and non-life risk modules]* This is a material change for firm XYZ. The non-life insurance SCR is materially greater than the previous capital requirements. Obviously, this is balanced to some extent by the technical provisions for RBC removing some of the prudential margins within the technical provisions that exist for the Report and Accounts. The justification for RBC is to allow for diversification of risk. A pure general insurer will be able to diversify its non-life insurance risk with its market and counterparty risk to arrive at its Basic SCR. Equally, a life insurer is able to diversify its life insurance risk with its market risk and counterparty risk to arrive at its Basic SCR. The new rules for life insurers allow for diversification between NSLT health insurance risk and SLT health insurance risk within the insurance risk module.	Thank you for your response. The Authority has reconsidered its approach to diversification between the life and non-life SCR modules and will amend the draft regulations to include an allowance for diversification.