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On the (Risk) Margin

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On behalf of the Risk Margin Working Party

The Risk Margin Working Party

- Set up following criticisms of the Risk Margin in the Treasury Select Committee Inquiry into EU Insurance Regulation
- Two main strands:
  - What can be done to fix known issues with the RM, either within Solvency II or using potential post-Brexit flexibility?
  - What should be the purpose of the RM, and how can that purpose best be fulfilled?
- Members:
  - Andy Pelkiewicz (Chair), Waqar Ahmad, Paul Fulcher, Chris Marsh, Stuart Reynolds, Andy Scott
  - Life Research Committee representative: Richard Schneider

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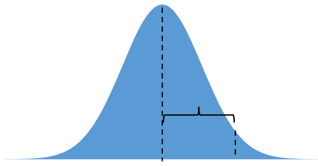
Back to basics: Why even have a risk margin?

What do we tell the policyholders about benefit security?



SCR: 99.5% VaR over one year

What about benefit security in the longer term?

Risk Margin aims to bridge the gap

Survive the next year, then transfer business

Cost of transfer typically exceeds best estimate

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The Solvency II approach

"Non-hedgeable"

$$RM = CoC \cdot \sum_{t \geq 0} \frac{SCR(t)}{(1 + r(t+1))^{t+1}}$$

6%

Swaps

Transfer to a "reference undertaking"

- No other business and remains closed
- De-risk assets (as far as possible)
- Assume reinsurance transfers with business
- Future management actions consistent with those of original insurer

"Non-hedgeable risks"

- Underwriting risks
- Residual market risk
- Counterparty default risk
- Operational risk

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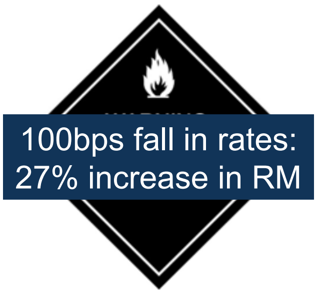
Right question?



Wrong answer!

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Source: "*Solvency II one year in*" – speech by David Rule, Executive Director of Insurance Supervision
Data as at 30 September 2016

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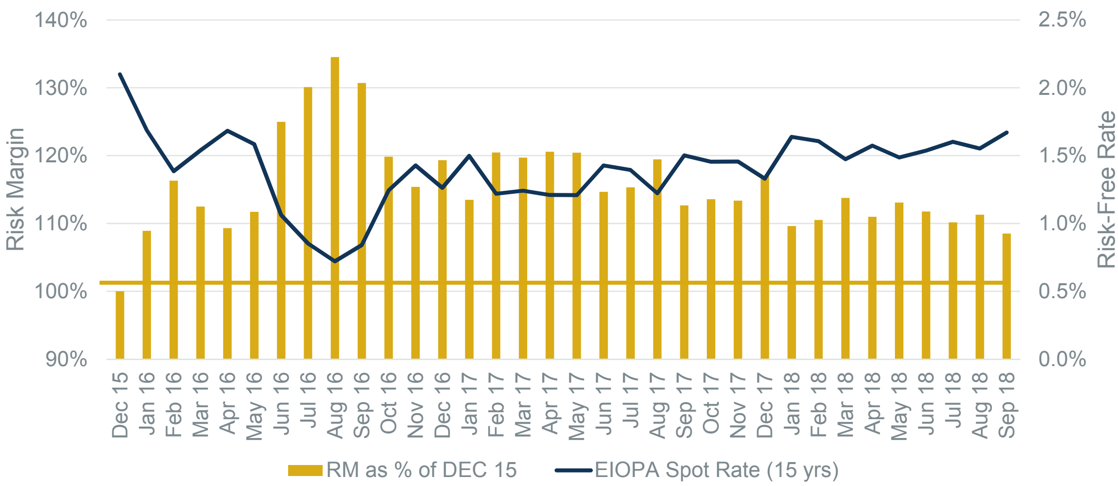
Interest rate sensitivity



Source: Working Party modelling

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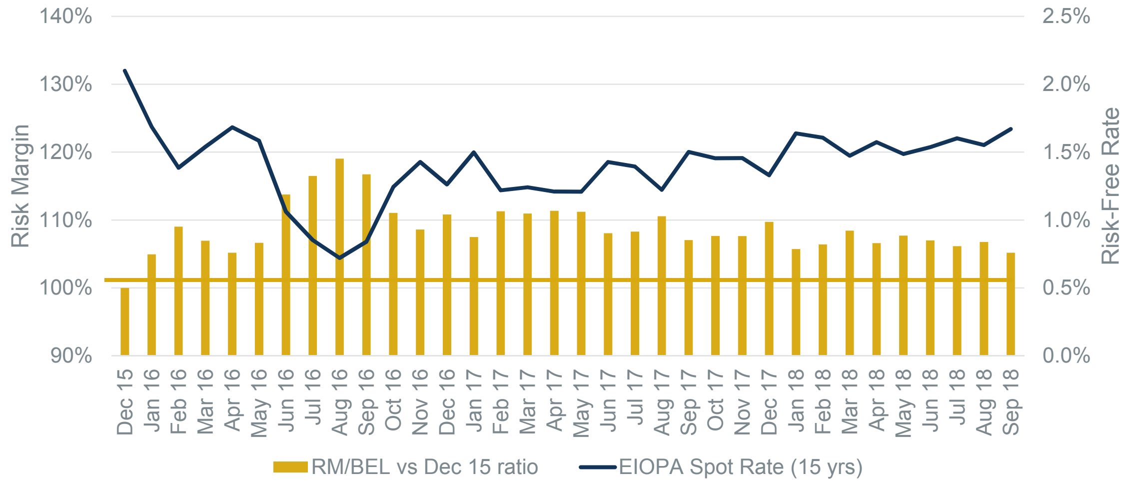
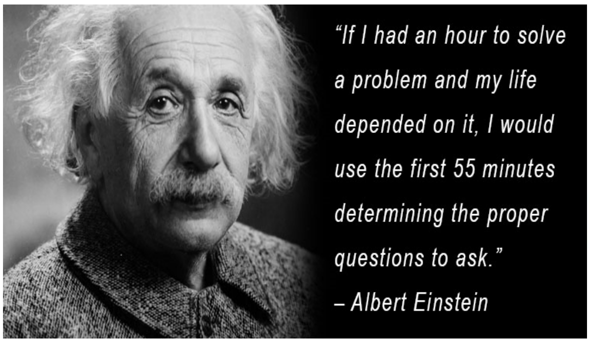
Interest rate sensitivity – a different perspective



Source: Working Party modelling

Qualities of a desirable risk margin



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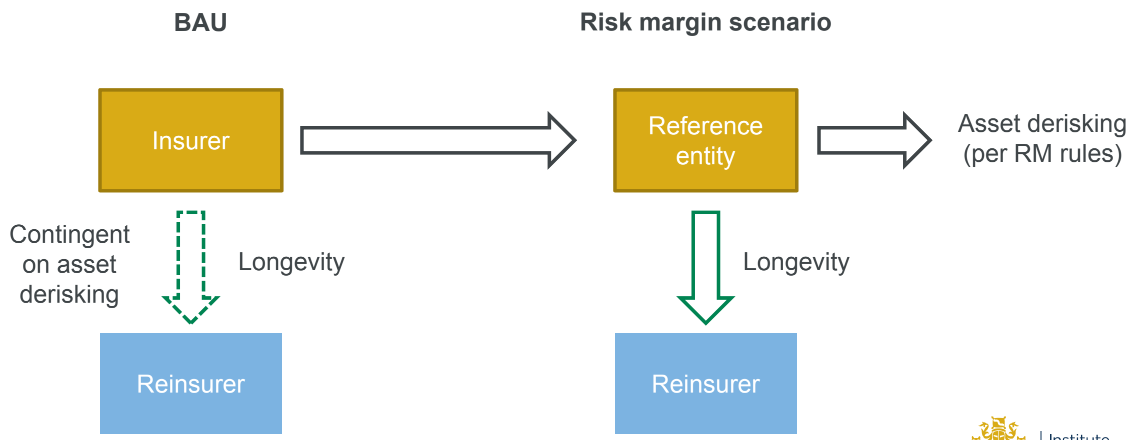
"Management action" solution



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Qualities of a desirable risk margin

- Practicality of calculation
- Stability over different risks (and time)
- Consistency between firms / objectivity
- Policyholder protection
- IFRS17 consistency
- Market consistency
- Counter-cyclical
- International Capital Standards consistency
- Right incentives

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Source: Groupe Consultatif, 2006 (for first six criteria) – these have been paraphrased by the Working Party for ease of presentation

Options for change: within Directive

Proposal	Justification	What needs to change
Lower cost of capital from 6%	Simplest change to reduce magnitude of issue	Level II Delegated Acts
Vary cost of capital with interest rates	Reduces (artificial) volatility and some theoretical evidence	Level II Delegated Acts
MA or VA used for SCR	Consistent with BEL (although market risk assumed to be derisked)	EIOPA Guidelines
MA or VA used to discount cost of capital	Insurer should be able to earn liquidity premium on capital held	Level II Delegated Acts
Tapering of lifetime risks	Theoretically justified Current method can produce paradoxical result	Level II Delegated Acts or Internal Model

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Options for change: more fundamental

Proposal	Justification	What needs to change
Link Risk Margin to reinsurance pricing	Market consistent and removes artificial incentives to transfer	Level II Delegated Acts or PRA acceptance of management action
Confidence level **PAD or (Tail-)VaR**	Cost of capital method has artificial volatility Alternative permitted under IFRS/ICS	Level I Directive
Replace RM + SCR with “run-off” SCR	Align with ability to meet liabilities as fall due	Level I Directive
No Risk Margin	ICAS regime didn’t have risk margin 50% prob. of meeting benefits post SCR shock	Level I Directive

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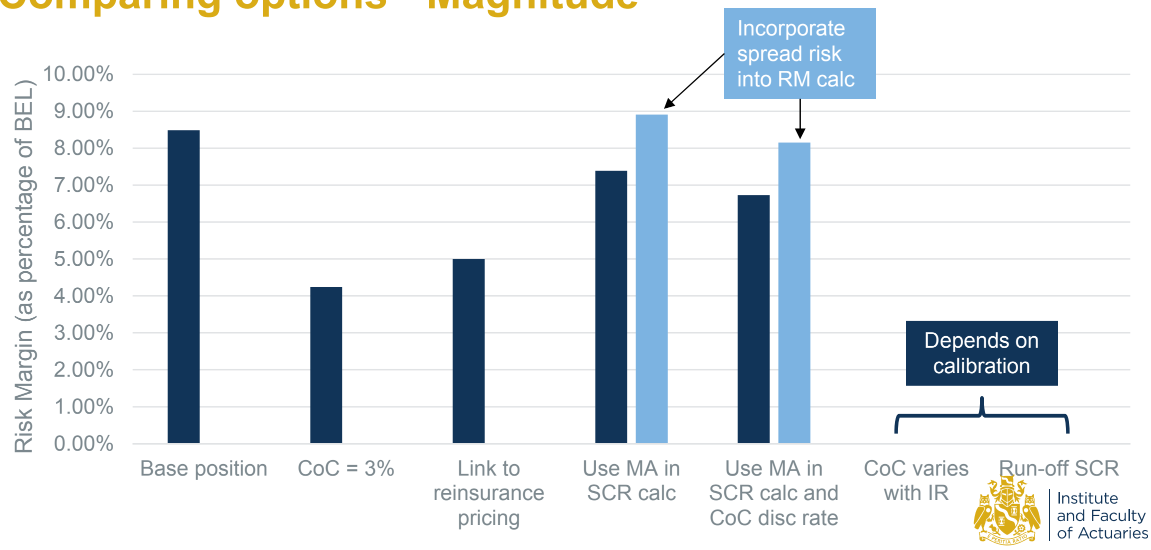
Comparing options - Magnitude



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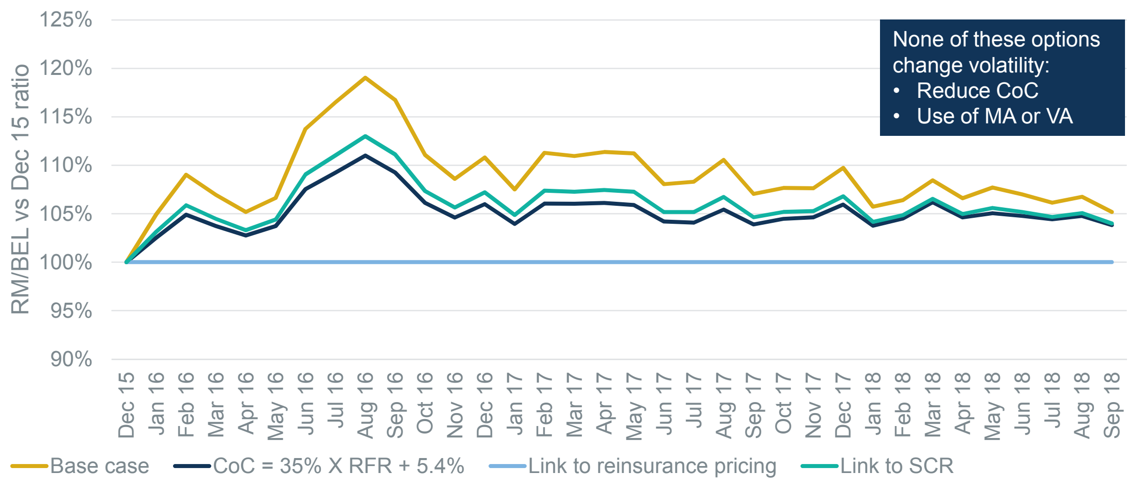
Source: Working Party modelling
As at 30 September 2018

Comparing options - Volatility

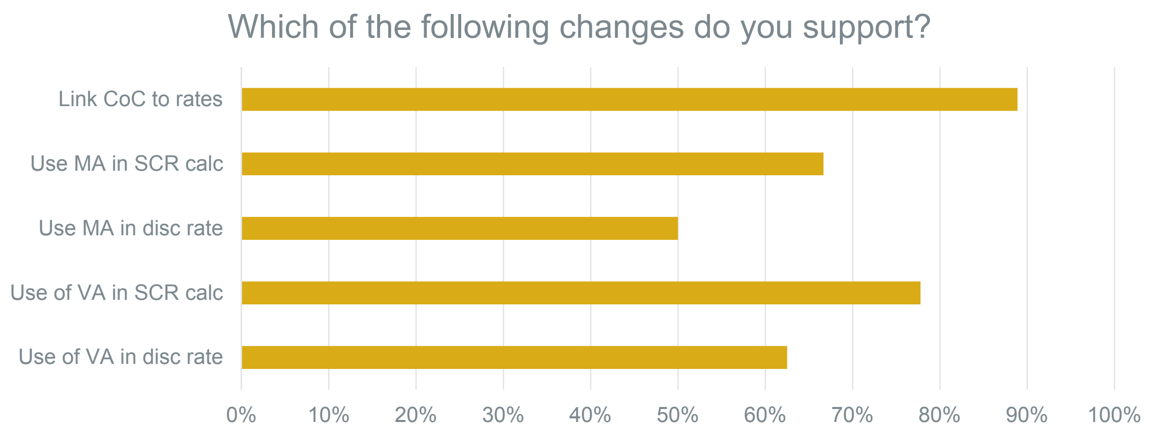


Source: Working Party modelling

Assessing the alternatives (work in progress)

	Reduce CoC	Link CoC to rates	MA or VA	Reinsurance pricing	VaR / PAD	Run-off SCR
Practicality	✓✓	✗	-	?	✗	✗
Stability over risks	-	-	-	✗	✓	✓
Objectivity / consistency	-	-	-	✗	-	✗
Policyholder protection	✗	?	?	✓	?	✓
IFRS 17 consistency	-	-	✓	✗	✓✓	✗
Market consistency	?	✓?	?	✓✓	?	?
Counter-cyclicality	-	✓✓	✓	✓✗	?	✓✓
ICS consistency	-	✓	-	✗	✓✓	✗
Right incentives	?	✓	-	✓✓	?	?

Industry views



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Source: Working Party survey of 9 firms

Questions

Comments

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