



Society of Actuaries in Ireland

## National Specific Templates for Insurers and Reinsurers under Solvency II

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*Response to Central Bank of Ireland Consultation Paper (CP 89)*

January 2015

## **A Introduction**

- A1 The Society of Actuaries in Ireland (“Society”) is the professional body representing the actuarial profession in Ireland. Many of our members work in the non-life and life (re)insurance industry. Some carry responsibilities relating to the determination of technical provisions for insurance liabilities. Others are engaged in designing, pricing and underwriting products and in managing the risks inherent in insurance portfolios. Many also carry broader management responsibilities, including strategy planning and implementation. We can therefore draw on a wide range of expertise when we contribute to debate on insurance matters.
- A2 In addition, the Society is an active member of the Actuarial Association of Europe (AAE) and is fully engaged in the AAE’s ongoing work on governance systems and prudential regulatory standards, especially in relation to the development of Solvency II.
- A3 We welcome the opportunity to submit this response to the Central Bank of Ireland (“Central Bank”) Consultation Paper 89 (CP 89), “National Specific Templates for Insurers and Reinsurers under Solvency II”.
- A4 We provide some general comments in Section B, together with responses to the specific questions on which comments were invited.

## **B. Consultation Questions and Responses**

### **1. Templates required for Groups, High & Medium High Impact individual undertakings**

#### **1.1 Non -Life Income Statement (Template no. NST. 01)**

1.1.1 NST.01 seems to assume that individual instruments are assigned to back the insurance liabilities by line of business. However, the portfolio of assets is usually managed as a whole. Although this portfolio is determined and managed by referencing the profile and distribution of the portfolio of insurance liabilities, individual instruments are not usually assigned to specific lines of business. Hence, investment income and expenses are not normally directly available by line of business, and therefore hypothecation would be required.

- We question whether it was the Central Bank’s intent to require such hypothecation, or whether the template was designed on the assumption that individual instruments are assigned to specific lines of business.
- We would welcome an opportunity to discuss the intended use of the template with the Central Bank, as we have concerns that the line of business analysis proposed will not necessarily provide the insights expected and might in fact give some false comforts.

1.1.2 General comments on all the non-life templates are provided in section 2.1, where we elaborate on concerns about the frequency and granularity of returns and indicate that, given the heterogeneity between different classes of business, applying the same data analysis approach to all classes might not be optimal or even advisable. We would be happy to work with the Central Bank to consider whether other datasets would deliver better insights and contribute to more effective use of limited resources.

#### **1.2 Life Income Statement (Template no. NST. 02)**

##### General Comments on Life Income Statement

1.2.1 This template seems to cover a lot of the items in Forms 1, 2 & 3 of the current regulatory returns under Solvency I. However, the split of information in this template is more detailed.

1.2.2 The template is split between “Insurance” and “Investment” contracts. It would be helpful to confirm if these are the same classifications that apply under IFRS? This categorisation does not apply anywhere else in the Solvency II Quarterly Reporting Templates (QRTs) and therefore there is an inconsistency between the lines of business classifications for this National Specific Template (NST) and the other QRTs. This will add to the reporting burden for firms.

1.2.3 The requirement to show results on an IFRS (or local GAAP) basis, and to use their insurance or investment splits, effectively requires quarterly calculation of those results; this is not a current requirement. We suggest that the change in reserves should be the Solvency II basis

change in reserves. It would also be helpful to keep product classification splits consistent with other Solvency II reporting templates rather than using the IFRS basis. Under the Solvency I regime, there is no requirement to produce quarterly IFRS numbers in order to complete regulatory reporting. It is unclear why this should be a requirement for Solvency II, particularly in light of the additional reporting burden Solvency II already places on firms.

- 1.2.4 Some of the information requested is already required under other Pillar 3 forms using Solvency II rather than IFRS classifications. We would question why results on a different reporting regime are being requested.
- 1.2.5 It is not clear what figure the template is trying to arrive at. Is it the operating profit for insurance contracts, with some information on the investment contracts shown separately?
- 1.2.6 It would be helpful to include (perhaps in the additional notes section) a requirement to disclose declared surpluses / transfers to the shareholder fund from the Life Assurance Fund on this template. This is currently in line 13 of Form 1 of the existing Solvency I returns.

#### Comments on specific line items

- 1.2.7 There is no line for individual pensions, group pensions, savings business, life single premium or PHI under the “Insurance Contracts” section of the template. Some of these contracts are classified as “insurance” under IFRS.
- 1.2.8 Premium is defined as “Written Premium” in the log file. This makes sense for new business. However, if the aim is to arrive at an accounts profit, should the existing business premium be on an “accounts accrued” basis?
- 1.2.9 The premium for “Business Transfers In” needs to be separated from other premiums. Should this include, for example, a group scheme that has been transferred from another insurance company? It could be difficult for companies to identify this separately. Also, “Business Transfers In” is not captured as new business; what is the rationale for this? Alternatively, does this line only refer to legal transfers of business?
- 1.2.10 We question the need to split investment income between realised and unrealised gains, as different definitions can be used to determine these.
- 1.2.11 Does the “Fee Income” line refer to fee income on investment contracts only? This would be the case if following an accounts basis.
- 1.2.12 Should the “Other Income” line be defined as “Any item of income which cannot properly be attributed to C1-C14” in the log file?
- 1.2.13 The claims lines include death and critical illness. There are no line items for “other” claim types. It should be clarified how maturities and partial surrenders are captured. Also, there should be consistency between premium categories and claim categories (see paragraph 1.2.7).

- 1.2.14 What is meant by “surrender” in respect of annuity contracts? An example would be useful.
- 1.2.15 The split of expenses is a lot more detailed than currently required on Form 2. In particular, claims management and investment management expenses will need to be separately identified. This may require companies to do a more granular expense analysis, so it would be important to define these terms clearly. If adopting an accounting approach, should the change in Deferred Acquisition Costs (DAC) be captured in the expense section?
- 1.2.16 The line “Change in Investment Contract Provisions” needs to be defined more clearly. Is it referring to the technical provisions under Solvency II (unit reserves +/- best estimate liability + risk margin) or just the unit reserves?
- 1.2.17 It is not clear why the “Change in Investment Contract Provisions” falls under the insurance contract section of the template. Also, it is unclear why it is captured in the expenses section.
- 1.2.18 Where is the “Change in Insurance Contract Provisions” captured? Without this, it is difficult to understand what the ultimate “Operating Profit” is trying to capture as it will not reconcile with the profit in the accounts. If the intention is to use Solvency II technical provisions, then it is unclear why an Insurance / Investment split is required (see paragraph 1.2.16).
- 1.2.19 The formula that arrives at the “Operating Profit” will not match the operating profit shown in a company’s accounts. For example, only the premium and claims on insurance contracts are captured. However, the investment income on all non-linked and unit-linked contracts (insurance and investment) is included, and the change in liability only seems to capture the investment contracts (insurance contracts excluded). It would seem that the change in insurance contract provisions is required to arrive at a sensible operating profit figure. This is the key figure on the form and it would be important to get more clarity on what it is trying to achieve.
- 1.2.20 There is no line item for Single Premium Group Pensions under “Investment Contracts”.
- 1.2.21 Similar to paragraph 1.2.8, the “Investment Contract Premium” is defined as “Written Premium” in the log file. This makes sense for new business. However, if the aim is to arrive at an accounts profit, should the existing business premium be on an “accounts accrued” basis?
- 1.2.22 Some pension contracts have benefits other than life cover. There is no line item to capture these other claim types.
- 1.2.23 For investment contracts, there are only entries for premiums and claims. There is no profit figure for this business. Is this intentional?

## 2. Templates required for Non-Life undertakings

### 2.1 General Comments on the Non-Life Templates

- 2.1.1 We note that all of the proposed NSTs are required quarterly, whereas current equivalent requirements (e.g. the “Solvency I equivalent” of NST.01 and NST.02) are annual and the EIOPA templates on which NST.04, NST.05 and NST.06 are based (S.17.02, S.18.01 and S.19.01 respectively) are only required annually (according to the consultation paper issued by EIOPA dated 27/11/2014).
- (a) We suggest that the volume of data collation proposed might not constitute the best use of limited resources. In the interests of efficiency and effectiveness of resource usage, we suggest that the frequency could be reduced for at least some of the templates without significantly compromising the usefulness of the information provided. If the Central Bank is willing to consider this, we would be happy to do more work to develop specific suggestions.
- (b) We suggest that the requirements should, in any event, explicitly allow insurers to have regard to the principle of proportionality (thus facilitating, for example, aggregation of data for small categories of business).
- (c) Requirements should be compared with equivalent requirements in other jurisdictions to ensure that insurers operating in Ireland are not subject to an excessive reporting burden. In addition, an impact analysis should be carried out in respect of the requirements.
- 2.1.2 As highlighted in section 1.1, non-life insurance companies do not typically manage their assets by line of business or hypothecate assets to business lines. Further practical difficulties of the non-life templates are outlined below.
- 2.1.3 The granularity of split (e.g. by type of claim and by distribution channel) places a significant additional reporting burden on firms, as firms do not produce their data in the format of the standard templates. It would be useful to understand whether the proposals are based on an assumption that the data is readily available at the proposed level of granularity, or a view that the extra work involved in collating data as proposed will be worthwhile in terms of significantly enhancing insights into the financial soundness of the business.
- Though we are mindful of the need for comprehensive data, we have some concerns that the level of granularity proposed might be disproportionate and might not achieve its aims.
  - Also, there is quite a degree of heterogeneity between different classes of non-life business and applying the same data analysis approach to all classes might not be optimal or even advisable.
  - We have some constructive suggestions that we feel will help the Central Bank achieve its objectives (e.g. suggestions as to how the impacts of changing portfolio mix within certain classes of business might be monitored) and would welcome an opportunity to discuss this further.

- 2.1.4 The additional data granularity for templates NST.03 to NST.07 is particularly onerous for reinsurers, given that in many instances the required level of data may not be supplied by the cedant. Often a reinsurance product will cover multiple lines of business and the exact split will not exist. It is likely that allocations would be required to separate the business to the level required in the templates and these allocations may limit the benefit of the results. Proportional reinsurance is included with direct insurance and may distort any analysis because of the use of approximate allocation. Also, the business may not be managed internally at the level described in the templates, which will hinder any expense allocation.
- 2.1.5 In the context of paragraphs 2.1.1 to 2.1.4, would the Central Bank consider allowing insurers to apply for dispensation either at a company level or by class of business? Alternatively, would the Central Bank consider adopting class-specific requirements, that is, to specify templates that are only required for certain classes of business?
- 2.1.6 It would be preferable if the Central Bank could accept the data in MS Excel format. This would significantly reduce the cost and time required by entities to meet the proposed requirements.
- 2.2 Non-Life Technical Provisions – Detailed Split by LOB and Distribution Channel (Template no. NST.03)**
- 2.2.1 There is an assumption in NST.03 that reserves are calculated at the level of segmentation outlined (10 categories for motor and 34 segments in total) and that reserves are recalculated quarterly for all lines of business. Reserving segments are based on the size and characteristics of each book and determined by judgement. Current reserving segments for all companies are unlikely to be consistent with the segmentation requested. In particular, this breakdown is likely to result in very small amounts for some lines – notably the 10 categories for motor.
- 2.2.2 It should be noted that firms will take different approaches to categorising claims by heads of claim; some firms will put any claim involving bodily injury into its Bodily Injury Triangles whereas other firms will split out each claim between the bodily injury and property damage components.
- 2.2.3 A full recalculation of reserves is not necessarily carried out quarterly. This is especially true for longer tail lines in which the information for one additional quarter will not always be sufficiently meaningful to warrant a recalculation of reserves. A quarterly recalculation for all reserves, particularly at this level of granularity, is likely to be a significant expense.
- 2.2.4 The split of Motor into Personal and Commercial and Injury / Damage is sensible for direct insurers but the split between Personal and Commercial is not practical or useful for a reinsurer, and the split between injury and damage may not be available for proportional reinsurance.
- 2.2.5 The Split of Liability into Employer’s Liability and Public Liability is sensible where the products are separate. However, we suggest that it may be helpful to clarify that Employer’s Liability, as written in Ireland and the UK, is seen as being part of Liability, whereas Workers Compensation, as written in continental Europe, is treated as part of Accident & Health and so is not included in Liability.

2.2.6 Some guidance on the categorisation of specialty classes such as Product Liability or Professional Indemnity between Public Liability and Other General Liability would be useful.

### **2.3 Non-Life Technical Provisions – Detailed Split by LOB and Country (Template no. NST.04)**

2.3.1 NST.04 is quite similar to NST.03, but with information requested by country as well. There is an assumption that this information is calculated by the country in which the risk is located. In practice, calculating reserves on a country basis will only occur for countries that are material for the business. Given the nature of the EU, a number of companies group small country exposures, and then separate them if they become material. In this respect, the practical difficulties for reinsurers to complete this template may be considerable.

2.3.2 The template provided allows for a split by distribution channel as well as country. This appears onerous and we draw attention to our comments in paragraph 2.1.3.

### **2.4 Non-Life – Projection of future cash flows (Best Estimate – Non-Life) detailed split (Template no. NST.05)**

2.4.1 NST.05 requires liability cash flows quarterly, and includes latent claims and a disaggregation of motor claims. Similar to our comment on the quarterly calculation of reserves in paragraph 2.2.3, a full recalculation of liability cash flows is not always performed quarterly so this would be an additional expense.

2.4.2 This template requires a separate allowance for "Latent Claims"; is this the same as "Events not in Data"/Binary events or is it something different? It would be helpful to define what is intended here, and whether it applies to Motor as well as Liability. Latent claims are always difficult to assess. Generally they are assessed in relation to a quantum rather than a cash flow. Determining a cash flow for claims that are not known to exist is problematic.

### **2.5 Non-Life Insurance Claims Information – Detailed Split by Distribution Channel and Claims Type (Template no. NST.06)**

2.5.1 NST.06 requires claim triangles in the same format as EIOPA's annual template. However, NST.06 is required quarterly and with additional levels of granularity. We draw attention to our comments in paragraphs 2.1.1 and 2.1.3.

### **2.6 Non-Life Premiums, claims and expenses – Detailed Split by LOB and Distribution Channel (Template no. NST.07)**

2.6.1 In relation to expense allocation, industry practice is to assess the likely expenses of a line of business and then compare actual to expected. However, expenses are allocated having regard to management's view of lines of business and it is unlikely that this will coincide with the EIOPA segmentation. We have doubts that requiring firms to perform an expense allocation every quarter will provide meaningful results and we question the proportionality of the requirement.

### 3. Templates required for Variable Annuity business

#### 3.1 VA Issue 1 – Basis for P&L attribution

##### General Comments

3.1.1 It should be recognised that entities may have very valid reasons for hedging to a basis different to that used for Solvency II valuations. For example:

- The Ultimate Forward Rate (UFR) departs from the market consistency principle of Solvency II. It is quite possible that the Solvency II level of the UFR will be reviewed and changed in the future. Therefore, some undertakings may prefer to use a yield curve that is more reflective of current market conditions.
- There is a body of opinion that valuing guarantees using the OIS is more appropriate than using LIBOR.

3.1.2 The primary purpose of the hedge P&L attribution is to assess the performance of the hedging program and to identify those elements that are not meeting the hedge objectives. Therefore, it would appear inappropriate to devote a disproportionately high level of effort to carry out a regular and detailed hedge P&L attribution using a liability valuation basis that is not itself part of the hedging program.

3.1.3 For Solvency II purposes, if undertakings are to get credit for the hedge program, they must use an internal model to calculate Market Risk Capital. Such undertakings must carry out an annual P&L attribution on the Solvency II basis. They must also perform and report on an ORSA. In this context, given that these are sources of information on how the hedge program affects solvency levels under the Solvency II basis, we suggest that consideration be given to moderating the proposed NST requirements.

##### Specific Comments on the advantages and disadvantages of various bases

###### Solvency II Basis

3.1.4 The advantage of using a Solvency II basis for P&L attribution is that it would provide a consistent manner by which the Central Bank could assess the risks and risk management of each firm. For example, consider two VA writers with the same policyholder liability; one firm may hedge on a US GAAP basis and may only hedge its FAS-157 liabilities and ignore the SOP03-1 liabilities (i.e. reserved and backed by traditional reserve assets), whereas a second firm with the same liability that hedges on an IFRS basis may hedge all of the liability.

- 3.1.5 The disadvantages of a Solvency II basis for P&L attribution include the following:
- (a) If a company is performing its hedging on a different basis, the requirement to perform a P&L attribution in the context of a Solvency II basis may be an onerous overhead in terms of calculation. These calculations would be required at the same time that firms are likely to be engaged in internal model approval processes, Solvency II process developments etc., which may lead to a less robust implementation than might otherwise be desired.
  - (b) The P&L attribution analysis may give misleading results owing to the presence of certain features of the Solvency II balance sheet that are not entirely market consistent, e.g. Ultimate Forward Rate, Credit Risk Adjustment, etc., whereas hedging firms are likely to use a pure market consistent curve. This is especially true for liabilities that occur after the Last Liquid Point.
  - (c) Even within this framework, some key differences can exist, e.g. correlation can vary from firm to firm or the stochastic form of ESG required to value liabilities can differ from firm to firm.

#### Company's own hedging basis

- 3.1.6 The advantages of using a company's own hedging basis for P&L attribution include the following:
- (a) Some form of reporting is likely to be in place already, which would reduce the burden on firms complying with this.
  - (b) It is likely that further improvements to the hedge process would occur over time and that these would involve communication with the Central Bank. It would be better if these discussions occurred on a consistent basis.
- 3.1.7 The disadvantages of using a company's own hedging basis include the following:
- (a) The hedging platform may contain certain elements that are subjective, e.g. fixed volatility assumptions rather than market-consistent assumptions.
  - (b) A company is more likely to have its Solvency II process subjected to external/internal audit controls.
  - (c) There may be adjustments contained within the hedging program that may not be consistent from firm to firm, e.g. own credit spread, etc.

#### Hedging basis with regular attribution of difference between the hedging and Solvency II results

- 3.1.8 Using a hedging basis with a regular attribution of difference between the hedging and Solvency II results would appear to be a reasonable compromise to choosing between the Solvency II basis and a company's own hedging basis.

### **3.2 VA Issue 2 – Attribution for reinsured business**

- 3.2.1 The Central Bank requires a “look-through” basis for the P&L attribution for direct writers of VA who have reinsured the guarantees to third parties and are rated “High” under the PRISM framework. In this section we provide feedback on some of the factors to be considered in applying the P&L attribution on a look-through basis.
- 3.2.2 For reinsured business, the key focus should be on the credit rating of the reinsurer and its ability to withstand losses. Focusing on the complex area of P&L attribution may divert excess attention and expert resources away from the more important issue of the reinsurer’s ability to meet its obligations.
- 3.2.3 As an example of paragraph 3.2.2 above, for pragmatic reasons a reinsurer may have an underperforming hedge program in relation to a cedant that represents a very small part of its overall portfolio. More importantly, focusing considerable resources (including regulatory resources) and attention on that part of the reinsurer’s hedging program that is specific to the cedant in question may divert attention away from the bigger picture and the more important issue of how the reinsurer is performing as a whole. It may be more valuable to understand the performance of the reinsurer’s hedging program as a whole rather than the potentially small component that relates to the cedant.
- 3.2.4 If the reinsurer hedges a number of different liabilities in aggregate, it may be difficult to untangle the P&L attribution for a specific entity. This could lead to issues in obtaining this information.
- 3.2.5 If the reinsurer has a number of different hedging programs, the ability to hedge well under one specific direct writer’s portfolio may not be very representative of the financial risk and stability of the reinsurer as a whole, given the reinsurer will have other portfolios. That is, a wider analysis may be required which considers the total portfolio and hedging policy of the reinsurer in question.

### **3.3 VA Issue 3 – Split between VA and non-VA business**

#### A Potential Methodology

- 3.3.1 The amount of capital supporting the non-VA business should be set aside initially and any spare assets could then be allocated to the VA element. One possible method is to allocate the amount of excess shareholder assets to cover the non-VA SCR in accordance with the firm’s target solvency coverage (i.e. provide those policyholders with the same capital level as represented to IFAs, investors etc.) or another percentage of (undiversified) SCR as specified by the Central Bank. The firm may be able to allow for the diversification benefit to reduce this capital resource requirement using one of the standard allocation of diversification techniques, such as Euler or Shapely methods etc. The balance of excess shareholder assets could then be allocated to the VA stress tests.

### **3.4 VA Issue 4 – Interaction between NST and ORSA**

- 3.4.1 One of the stated purposes of the NST is to examine areas of potential hedge inefficiency. This suggests that the stresses should be applied on the valuation basis used to specify the hedge objectives, and not necessarily the Solvency II basis.
- 3.4.2 Arguably, many of the stresses proposed for the NST are extreme. We question whether there is real value to be gained from generating these stresses quarterly; we suggest that consideration be given to changing this to an annual requirement.
- 3.4.3 The levels of shocks presented need to be carefully selected as many firms may target certain criteria when formulating their hedge strategy; there may be explicit targets in terms of P&L volatility, Capital Management, etc. The ORSA and risk appetite are likely to reflect these requirements within the various risk metrics that are regularly reported to the Board. Some of the stress and scenario tests may be suitable to monitor for the company's risk management but not all, and it is possible that from time to time the pertinent stresses will change.

### **3.5 VA Issue 5 – Nature of scenario tests**

- 3.5.1 The potential occurrence of the more extreme shocks within a single day seems very remote. Therefore, in the interests of efficiency and effectiveness of resource usage, annual rather than quarterly test runs of remote scenarios would be more appropriate. The approach also ignores key risk mitigation features of some hedge programs such as rebalancing triggers.
- 3.5.2 While there are a large number of shocks included in the NST, there is a risk that too much confidence is placed in these. The ORSA is the ideal place where these should be tested as some VA-specific risks will not be captured by these scenarios. Examples of impacts that are not assessed include the following:
- For some VA product offerings, the guarantees may be dynamic in nature and the scenario tests do not test this, e.g. some writers have ratchets included. The worst type of scenario for such a feature is a protracted boom-bust cycle where growth over a long period is locked in over a variety of ratchet reset periods and then followed by a large downturn in the market.
  - In an improving market, policyholders lapse at higher levels than anticipated, leaving a dynamic hedger exposed to holding a basket of negative hedge assets.
  - Where VA writers offer guarantees that are underwritten on corporate bond funds, the stresses do not reflect the credit-worthiness of different corporate bond funds or the difference in durational impacts in periods of high stress.
  - Where companies have employed fund-based mechanisms to reduce their volatility exposure, such as an automated rebalancing algorithm, a stress test may produce false results if the rebalancing feature is not reflected.

3.5.3 There is a risk that companies may have many other types of liabilities, all of which need to be examined within the ORSA, reducing the scope for VA-specific scenarios.

**3.6 Variable Annuity – Daily Attribution - Liability (Template No. NST.08)**

3.6.1 No specific comments on the templates other than those covered under “VA Issues 1 – 5” above.

**3.7 Variable Annuity – Daily Attribution - Asset (Template No. NST.09)**

3.7.1 No specific comments on the templates other than those covered under “VA Issues 1 – 5” above.

**3.8 Variable Annuity – Daily Attribution - Other (Template No. NST.10)**

3.8.1 No specific comments on the templates other than those covered under “VA Issues 1 – 5” above.

**3.9 Variable Annuity – Daily Attribution – Stress tests (Template No. NST.11)**

3.9.1 No specific comments on the templates other than those covered under “VA Issues 1 – 5” above.

*Please direct any questions on this paper to Yvonne Lynch, Director of Professional Affairs, Society of Actuaries in Ireland, at the contact details overleaf or at: [Yvonne.Lynch@actuaries.ie](mailto:Yvonne.Lynch@actuaries.ie).*



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