GIBRALTAR FINANCIAL SERVICES COMMISSION

Solvency II Frequently Asked Questions

Results of Year-End 2016 Quality Assurance exercise

This document provides answers to those issues which commonly arose during the PwC Solvency II Balance Sheet, Own Funds and Standard formula SCR Quality Assurance (QA) exercise completed earlier this year.

General

What is Gibraltar Financial Services Commission's (GFSC) approach on materiality?

We expect firms to derive their Solvency II calculations on a best estimate basis. Amounts that can be justified to be immaterial may be calculated using a proportionate approach.

Regulatory reporting should ensure that all material risk exposures are individually identified and while an 'Other' category may be acceptable (for example where there is a small amount of non-GBP exposure), in aggregate this should not exceed 10% of the total for that item (e.g. Gross Claims Provision). For example, where business is predominantly written in GBP, but Euro exposures make up 2% and USD 2%, then it would be acceptable to aggregate the non-GBP exposures into 'Other'. However, if the Euro exposures amounted to 9%, then we would expect to see a separate Euro category. For exposures within the 'Other' category, proportionality in calculating the best estimate may apply.

How much documentation is enough?

Documentation should be sufficient for an educated independent reader to be able to follow the governance, approach and assumptions used and, where appropriate, the justification for the area to which the document relates. The QA exercise noted a number of instances of the absence of adequate governance or its documentation, as well as a general lack of justification.

Technical Provisions (TPs)

How should firms allow for Events Not In Data (ENID)?

Solvency II (SII) requires firms to consider all possible future cashflows. It is likely that firms can envisage future scenarios which are not present in the data used to develop Gross Claims Provisions, for example, particularly if the firm is using limited history for its projections. We expect firms to consider the scenarios which are appropriate for their business in developing their best estimate of future cashflows and to justify their approach. We expect that, apart, perhaps, from reserve risk for short-tail business, the ENID provision would not be zero.

Why do firms need to allow for Written But Not Incepted (WBNI) business?

The solvency regime seeks to address the totality of a firm's insurance obligations, including those that have yet to incept. Firms should consider their processes for new and renewal business, and assess the volume of risks and associated future cashflows. To the extent that the firm assesses and justifies the volume to be immaterial, the calculation can be carried out on a proportionate basis.

In this regard, firms need to consider all the cashflows that might be generated within the contract boundaries such as cancellation or adjustment fees.

What level of segmentation of business is required?

It is expected that firms will be reserving by homogeneous risk group, allowing for the credibility of the data. The QA exercise noted some issues regarding the allocation of TPs between Motor Liability and Motor Other. We expect firms to be able to split their motor claims by 'own property damage' and 'third party property damage and third party liability' and apply an appropriate and justified split to (or allocation of) the premiums in order to report in line with SII rules.

Settled PPOs need to be separately identified and reported under ‘annuities stemming from non-life insurance contracts’ including completion of all the relevant QRTs.

What should be included in SII firm’s best estimate?

Technical Provisions need to include all future insurance-related cashflows on a best estimate basis. This includes expected profit commissions on a best estimate basis as well as allowance for reinstatement premiums, adjustment premiums and lapses, for example. Where profit commission is allowed for in TPs, we expect the impact to be assessed in the ORSA.

The QA exercise identified firms which had not documented its justification that the TPs were a best estimate including the selection of the loss ratio to use to derive Premium Provisions. Some firms also failed to include receivables/payables within credit terms in TPs, discussed further under the next question.

We expect that future premium income will be relatively immaterial (perhaps adjustment premiums) within Claims Provisions but more material (e.g. instalment income) within Premium Provisions.

Firms should allow appropriately for outwards reinsurance premiums corresponding to bound inwards risks. Where the terms and cost of outwards reinsurance are material, such as in respect of minimum premiums, these should be discussed in the ORSA.

When should insurance receivables and payables be included within the TP calculation?

The main criterion is whether "an amount [is] past-due for payment". We consider this to be based on the due date of the relevant contractual arrangement. For instance, where amounts are receivable from intermediaries, this is dependent on the credit terms with the intermediary. Where amounts are received directly from policyholders, it is the payment terms with the policyholder. When amounts are within terms, they should be included within TPs.

Credit terms should be considered in the ORSA. Where credit terms are high or terms are extended there may be an issue of standard formula inappropriateness.

In the extreme case where the firm is not able to evidence any credit terms, the GFSC would consider the full balance to be due immediately and any amounts outstanding to be past-due.

Which expenses should be included in the TP calculation?

All expenses which will be incurred in servicing the bound liabilities need to be included in the TPs. This includes investment expenses (not offset against investment income), general management expenses, any necessary reinsurance placement expenses as well as claims handling (where applicable), policy administration expenses and premium taxes. Expenses can be derived on a going-concern basis and so do not need to include allowance for redundancy costs, for example. Assumptions, however, need to be justified.

What level of granularity does the GFSC accept for discounting?

This was one of the findings of the QA exercise and is addressed in the question above regarding materiality. Firms need to consider the best view of appropriate payment patterns for gross, reinsurance, attritional and large claims, for example, and if material should discount using the appropriate patterns. If the firm can justify immateriality, then using the same pattern may be a reasonable approach but will need to be justified regularly. Similarly, the use of a single yield curve, despite exposures in multiple currencies, may be justifiable, though firms still need to report their currencies appropriately.

What issues should firms be aware of in calculating the Risk Margin?

Generally, the Risk Margin calculation was reasonable. A number of firms used commercial software and we are aware that there have been some improvements since the QA exercise. Firms should ensure that they understand the methodology and assumptions used and that the model used is appropriate. Some firms erroneously excluded credit risk from the calculation.

What is the GFSC's approach to 'Future Management Actions'?

Article 23 of the Delegated Acts refers to future actions. We expect these to be considered and the rationale documented. If appropriate, future actions should be evidenced by similar actions having been taken in the past. This issue seems to have been most prevalent in respect of reinsurance placement.

Other Balance Sheet Items

What does the GFSC expect in respect of Deferred Tax calculations?

The SII Balance Sheet will be different to the GAAP Balance Sheet. Firms should therefore re-assess and justify the deferred tax position based on the SII amounts. If a deferred tax asset is to be included on the basis of a temporal difference between the net assets on a GAAP and Solvency II basis, firms also need to support this by justification using a recoverability assessment based on SII profitability. As a tier 3 own funds item firms should also consider the classification points of Article 77 for any deferred tax assets.

Should firms be considering the use of the Loss Absorbing Capacity of Deferred Tax, we expect them to discuss this with us ahead of time. The GFSC is reviewing each approach and its justification on a case-by-case basis. Where we do not find elements of LACDT to be adequately justified, we are requiring reduced credit within the SCR. The utilisation of LACDT must meet the requirements of the Solvency II Commission Delegated Regulations (EU) 2015/35 (namely Article 207) and the EIOPA Guidelines on loss absorbing capacity of technical provisions and deferred taxes. We expect the quantum of LACDT to be set out and relevant justification of each element of LACDT provided. Under Gibraltar tax legislation we consider the possible elements to be of the following types: i) an offset against a deferred tax liability (DTL) on the SII Balance Sheet; ii) an offset against any emerging current year tax liability; or iii) an offset due to the projection of modelled future taxable profits generated in a post SCR shock scenario. In Gibraltar, investment gains are not taxed, and investment losses are not tax deductible. Therefore the market risk module should be removed from the scope of a LACDT adjustment.

In respect of the use of future taxable profits (post SCR) stress to contribute to LACDT, we consider this to be the most judgmental aspect of application, and therefore the area requiring the most justification:

- We consider a planning horizon of beyond 3 years to be too speculative when modelling future taxable profits.
- We find the assessment of future taxable profit to be improved where a firm presents a number of different scenarios, and is able to demonstrate that it is probable that they will have future taxable profit available after suffering the instantaneous loss across these scenarios.
- While we note the challenges associated with envisaging potential 1-in-200 scenarios, these need to be sufficiently severe to represent a full SCR loss.
- The scenarios need to adequately envisage the prospects of the insurance company after suffering an instantaneous 1-in-200 loss. The assumptions behind this and balance sheet impact of these assumptions should be clearly set out.
- The manner of recovery should also be set out and justified. An SCR coverage of greater than 100% is required in order to avoid the placement of regulatory restrictions on business plans.

What assets and liabilities should be included in 'Any Other Assets/Liabilities'?

The QA exercise identified that a number of firms classified a range of assets/liabilities in ‘Other’ whereas a more thorough analysis would have identified a more appropriate category. This issue was also apparent regarding the allocation between ‘Insurance’ and ‘Trade’. One example was regarding profit commissions which generally would be included in TPs.

Similarly, firms need to analyse receivables according to credit terms. If these amounts are within credit terms, they are part of TPs; if they are outside credit terms, they are classified as Receivables.

Please note that, unless there is a legal right of offset, balances need to be separately included in payables and receivables.

What is the GFSC’s position regarding the MIB levy?

We are conscious that the position regarding the levy varies depending on when the firm started writing Motor business. We believe that where there is a clear liability based on business already bound, firms should include a provision.

What are the common issues regarding the valuation of assets and liabilities?

All assets/liabilities need to be valued at fair value and up-to-date. Valuation methodology needs to be justified and documented. Some specific issues noted were:

- Valuations should include accrued interest.
- Property Plant and Equipment should be valued using the revaluation method and where adjustments are made to the latest independent valuation, the rationale for the adjustment should be justified.
- Participations should be valued using the adjusted equity method.

Firms also need to ensure that assets are classified appropriately, for example:

- Participations should be classified as such only if firms own more than 20% of voting rights.
- Properties should be clearly classified as either for Own Use or third-party.
- Collective Investment Undertakings should use the ‘look-through’ approach with an appropriate control framework around the use of third-party data.
- Short-term deposits may be appropriately categorised as ‘Deposits other than Cash Equivalents’.

Own Funds

What is GFSC’s latest view regarding the cancellation of dividends?

We believe that firms need to ensure that any announcements of dividends should make it clear that these may be cancelled prior to payment if the SCR is not covered. We would typically expect this to be included in a firm’s Articles of Association. Where it is not, it needs to be explicitly stated within each dividend announcement.

What are the other common issues with the classification of Own Funds?

Firms need to justify the categorisation of preference shares/subordinated liabilities against the appropriate SII criteria and Guidelines.

Firms also need to have a process to consider if any assets should be classified as ‘ring-fenced funds’, which would have an impact on the calculation of the SCR.

Standard Formula SCR Calculation

A number of firms used outsourced software in order to carry out the SCR calculation. Firms need to ensure they are using the latest version of the software, that they fully understand the basis of the calculation and that it is appropriate for them. Firms are responsible for their SCR calculation.

Similarly, some firms outsourced the calculation of Market Risk. Again, firms need to take responsibility for the calculation and ensure it is correct.

We understand that, subsequent to the QA exercise, some improvements have been made to the most commonly used model, so our comments attempt to reflect the latest position.

What were the common QA issues regarding the calculation of Non-Life Underwriting Risk?

There were a number of specific issues regarding the calculation of Non-Life Premium and Reserve Risk, in particular:

- Firms need to give more consideration to the derivation of FP(future) and FP(existing) with appropriate justification of their methodology. This should be consistent with firm's approach to WBNI.
- Settled PPOs need to be included within the Life Underwriting Risk calculations.
- Where risk volume measures do not include discounted expenses, we expect to see formal justification for the exclusion, including an assessment of the adequacy of any claims handling provisions held by third-parties in a stressed situation. Volume measures should include reinsurance bad debt and exclude future premiums.

Article 147(4) may allow for an alternative volume measure, utilising only projected premium volumes. In accordance with paragraph (c) of the article we expect firms to have talked to us to confirm this treatment.

Regarding Lapse Risk, this was one area where firms need to understand the assumptions underlying the calculation and ensure they are appropriate. In addition, where firms coinsure, they should calculate lapse risk in respect of the underlying insurance contracts.

For Cat Risk, firms need to ensure they have considered the EIOPA guidelines paper on non-life Cat Risk.

In addition, they need to justify the assumptions they make (e.g. regarding Cresta zone data or allowances for treaty indexation).

Similarly, what were the issues for Life Underwriting Risk?

Firms need to include the SCR for mass lapse risk and where management actions are included, they should be appropriately justified. Also, firms need to ensure that policies only contribute to the SCR where the stress increases the TPs.

Where were the problems in the calculation of counterparty default risk?

Firms need to ensure that counterparties are grouped by the ultimate parent (e.g. Society of Lloyd's) and that the credit quality step for the combined group is calculated correctly.

Any risk-mitigating derivatives, as well as cash holdings, should be included in the calculation.

What areas of Market Risk caused the most difficulties in the SCR calculation?

There were a number of instances where incorrect or out-of-date parameters were used e.g. yield curves, equity symmetric adjustment, which is not acceptable.

Where firms hold collective investment undertakings, we expect them to implement the look-through approach. Should this not be possible, the Directive may allow alternative treatment (using target fund allocations per Article 84(3) or applying the type 2 equity charge per Article 168(3)). We would expect firms to discuss the position with us.

Firms should apply the interest rate risk stress only to the underlying risk-free rate and not to the spread over the risk-free rate.

Under concentration risk, for exposures to group counterparties, the concentration risk charge may be exempt in certain circumstances. If a firm is applying this exemption, it needs to be documented how the full criteria of Article 184(2)(b) is demonstrated to be met.

Similarly, where an equity is treated as a strategic investment, justification against the criteria of Article 171 needs to be evidenced in documentation.

Moveable property should be classified as Type 2 equity.

Are there any other factors that firms need to be aware of in the SCR calculation?

Firms should ensure that reinsurance contracts meet the requirements of Articles 209-211 and 213. Where collateral is used to support risk mitigation, firms should ensure that the collateral also meets the requirements of Article 214.

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