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Slaughter and May Podcast
Solvency II: Provisions

Robert Chaplin	Hello and welcome. I'm Robert Chaplin, one of Slaughter and May's corporate insurance partners. With me is Beth Dobson, our insurance practice support lawyer. This is our overview of technical provisions under Solvency II. For more information please see chapter 5 of our Solvency II App. If you don't already have the App, please email solvency.two@slaughterandmay.com to request access.
Beth Dobson	Technical provisions are the provisions which insurers must establish to reflect their liabilities under insurance policies they have issued. They are the starting point for working out the capital resources which insurers need to hold. Historically, technical provisions were calculated as a prudent best estimate of the expected cashflows under the policies, discounted by an appropriate amount to reflect the time value of money. Key changes introduced under Solvency II were: • the calculation is now a realistic rather than a prudent best estimate; • the discount rate is now based on centrally derived risk free rates rather than expected investment return on assets actually held by the insurer - subject to adjustments under the matching adjustment and the volatility adjustment; and • insurers must hold a "risk margin" as part of technical provisions, in addition to the best estimate. The best estimate is intended to be an estimate of the insurance liabilities of the firm over the lifetime of those liabilities. It should correspond to the "probability-weighted average of future cash flows under relevant contracts, taking account of the time value of money using the relevant risk-free interest rate term structure". Cash flows should be calculated gross of amounts recoverable from reinsurance and SPVs, which are dealt with on the asset side of the balance sheet. The calculation should include, for example, expected premiums and benefit payments, expenses, and payments between insurers and intermediaries related to insurance obligations. The value of financial guarantees and options should be taken into account, including realistic assumptions regarding the likelihood of options being exercised and of lapses and surrenders.

	In calculating the best estimate, insurers can take into account assumptions regarding future management actions. This is particularly significant with-profits business, where insurers may be able to respond to adverse market conditions by taking actions such as smoothing bonus allocations. The assumptions must, however, be realistic.
Robert Chaplin	Once the cash-flows have been calculated, they can be discounted to reflect the fact that some liabilities only need to be met in the future, and that investment returns can be earned on assets in the meantime. As mentioned, the basic position is that cash flows should be discounted using the risk free rate for the relevant currency and maturity of the liabilities, set by EIOPA on a monthly basis. The rates are based on swap rates and for maturities beyond the applicable last liquid point are calculated on an extrapolated basis. Risk free rates converge towards the "ultimate forward rate", which is the sum of an expected real interest rate and an expected inflation rate. The methodology used for the extrapolation of risk free rates has been subject to some criticism and EIOPA is consulting on amendments as part of the 2020 review of Solvency II. The decision on where to set the last liquid point can, for example, have a significant impact on technical provisions as ultimate forward rates tend to be higher than current risk free rates. In certain circumstances, risk free rates can be adjusted by the matching adjustment or the volatility adjustment. The matching adjustment is discussed in Chapter 6 of the App and is the subject of a separate podcast. The volatility adjustment cannot be used in respect of the same set of liabilities as the matching adjustment but, unlike the matching adjustment, can be used for any class of business. In the UK the matching adjustment has tended to provide the greater benefit to insurers and it has therefore been more widely used. The volatility adjustment is an adjustment to the risk free rate which is intended to mitigate the impact of short-term volatility and therefore helps to prevent pro-cyclical investment behaviour by insurers. It adds a fixed spread adjustment to the risk free rate curve, based on a risk-corrected spread on the assets in a reference portfolio, calculated by EIOPA on a currency and a country basis. There have been some concerns regarding the prudential basis for the volatility adjustment and its methodology. EIOPA has consulted as part of the 2020 review on possible changes to the way the VA is calculated, including possible changes to make it more undertaking-specific.
Beth Dobson	The second component of technical provisions is the risk margin. This is the amount required on top of the best estimate to ensure that the technical provisions reflect the amount that an insurer would be expected to require to take over another firm's insurance obligations. It is intended to represent the cost of holding sufficient own funds to match the SCR necessary to support the relevant insurance liabilities.

	The risk margin has been one of the most criticised elements of the Solvency II regime. It is, in particular, highly sensitive to movements in interest rates and industry has argued that it results in excessively high levels of technical provisions when interest rates are low. Despite this, EIOPA has not recommended any change to the risk margin methodology in its 2020 review of Solvency II. In contrast, the UK government has issued a call for evidence on various possible future changes to the post-Brexit Solvency II regime, including amendments to the risk margin. It has not made any concrete proposals for change at this stage, but has invited stakeholder input on possible options.
Robert Chaplin	Finally, transitional measures are currently available which can smooth the transition from pre-Solvency II requirements up until 2032. These come in two forms – the Transitional Measures on Technical Provisions – or TMTP - and the Transitional Measure on the Risk Free Rate. The TMTP is more commonly used in the UK and allows firms to apply a transitional deduction to technical provisions. This is calculated as a proportion (decreasing on a linear basis each year) of the difference between the firm's calculation of technical provisions under the pre-Solvency II regime and its calculation of technical provisions under Solvency II. In general, transitional measures can only be applied to business written before 1 January 2016. The PRA has confirmed, however, that the TMTP can be recalculated where a firm's risk profile changes, for example where there is a portfolio transfer of business which was written before the cut-off date or material changes in a firm's reinsurance programme. Where there are material changes in best estimate assumptions used to calculate technical provisions, these should be reflected consistently in the calculation of the pre-Solvency II technical provisions as well as the current calculation. This does not mean the assumptions will necessarily be the same in both cases but firms must consider the impact on both calculations. In its consultation on the 2020 Solvency II review, EIOPA expressed some concerns around the current use of the transitional measures in respect of technical provisions. EIOPA reported that, whilst the transitionals are intended to smooth the transition to full compliance with Solvency II, at the end of 2017 out of the 168 undertakings applying these transitionals, 139 would have met the SCR without them. EIOPA considers that this may create a distorted solvency position which could incentivise undertakings to take higher risks. It has not, however, recommended the phasing out of or material amendments to the use of the transitionals. This brings us to the end of this podcast. If you have any questions about technical provisions please get in touch with either of us or your usual contact at Slaughter and May.