At a glance

EIOPA finalises proposed changes to SCR Standard Formula

What's new?

- On 28 February EIOPA finalised its second and last set of Advice to the European Commission on Solvency Capital Requirement (SCR) standard formula changes. The Advice includes proposed changes to the design and / or calibration of some elements of the standard formula, together with some additional simplifications.
- It follows on from the first set of Advice published in October 2017. This paper covers both sets of Advice.
- The Commission now will consider the Advice and is expected to finalise its review of the SCR by December 2018.

What does this mean?

- Despite the discontent expressed by many stakeholders there are no proposed changes to the cost-of-capital used in the Risk Margin (RM). EIOPA suggests that the other components of the RM will not be reviewed until 2021.
- Proposed changes that might result in an increase to firms' SCR include:
  - Interest rate risk (IRR): EIOPA considers the current stress method underestimates IRR in low interest rate environments. It proposes moving to a 'relative shift' approach which is expected to result in a higher capital requirement for this module. It also proposes to implement the change gradually over the next three years.
  - Loss absorbing capacity of deferred taxes (LACDT): EIOPA proposes that there should be additional criteria for the calculation of deferred taxes after the shock loss, reflecting key principles EIOPA has developed in this regard. It proposes that these principles are incorporated in Level 2 legislation to increase regulatory convergence. These changes could limit the credit that can be taken for LACDT, in particular by constraining the ability to take account of assumed future profits in the post stress scenario in a number of ways.
- Elements that represent a relaxation of current requirements include:
  - Unrated debt: It will be possible to assign a credit quality step of either 2 or 3 to unrated debt based on internal assessments subject to meeting certain conditions.
  - Unlisted equity: It will be possible to classify some unlisted equity as 'type 1' subject to certain conditions being met.
- EIOPA proposes a number of recalibrations to the premium and reserve risk and natural catastrophe risk sub modules.
- Other proposed simplifications and re-designs include: look-through approach, catastrophe risk, market risk concentration, currency risk at group level, counterparty default risk module (treatment of derivatives and risk mitigation techniques), lapse risk allowed to be calculated at HRG rather than policy level, and a new simplification to allow SCR calculation without considering diversification benefit.

What do firms need to do?

- Firms that calculate their SCR using standard formula should familiarise themselves with the Advice and work to understand what the proposals will mean for them.
- In particular, those with significant IRR capital charges and firms that benefit from LACDT may wish to model the proposals to understand their impact.

Next steps

The Commission is due to finalise its review by December 2018. Changes might become effective during 2019.

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