

**Comments Template on
Discussion Paper on the review of specific items in the Solvency II
Delegated Regulation**

**Deadline
3 March 2017
23:59 CET**

Name of Company:	Thomas Miller & Co Limited	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ Do not change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool ⇒ Leave the last column <u>empty</u>. ⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph or a cell, keep the row <u>empty</u>. ⇒ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. <p>Please send the completed template, <u>in Word Format</u>, to CP-16-008@eiopa.europa.eu</p> <p>Our IT tool does not allow processing of any other formats.</p> <p>The numbering of the questions refers to the discussion paper on the review of specific items in the Solvency II Delegated Regulation.</p>		
Reference	Comment	
General Comment		
Q1.1		
Q1.2		
Q1.3		
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Q3.11		
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Q4.1		
Q4.2		
Q5.1	<p>We provide management services to a number of mutual insurance companies that write annual policies, all coinciding with the company's financial year. The policies are typically renewed one month prior to their inception date.</p> <p>Let $T(t)$ represent the date, with t in years from the SCR calculation date at the company's financial year end. Assume that the premium earned in each year is 120.</p>	

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Then under the current definitions of the volume measure for premium risk and ignoring discounting:

P_s = estimate of premiums to be earned between $T(0)$ and $T(1) = 120$

$P_{(last,s)}$ = premiums earned between $T(-1)$ and $T(0) = 120$

$FP_{(existing,s)} = 0$ (as the company writes annual policies)

$FP_{(future,s)}$ = estimate of premiums to be earned for contracts bound between $T(0)$ and $T(1)$ excluding premiums to be earned during the 12 months after the initial recognition date = $120 \times \frac{1}{12}$ (as the annual policies incepting at $T(1)$ are bound at $T(\frac{11}{12})$ so the premiums to be earned between $T(\frac{11}{12})$ and $T(1 - \frac{11}{12})$ are excluded, leaving only the premiums to be earned between $T(1 - \frac{11}{12})$ and $T(2)$)
= 10

$V_{(prem,s)} = \max(P_s; P_{(last,s)}) + FP_{(existing,s)} + FP_{(future,s)}$
= $\max(120; 120) + 0 + 10$
= 130

If the definition of $FP_{(future,s)}$ is changed to only exclude the premiums to be earned during the following 12 months (i.e. between $T(0)$ and $T(1)$), then the results become:

$FP_{(future,s)} = 120$ (as the annual policies are incepting at $T(1)$ so none of the premiums will be earned between $T(0)$ and $T(1)$)

$V_{(prem,s)} = \max(120; 120) + 0 + 120$
= 240

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i.e. the volume measure almost doubles. This would significantly increase the company's SCR.

We recognise that there is a need to include new business expected to be written over the following 12 months when calculating the SCR. We would however like to make the following points:

- Under the Solvency II Directive, the SCR is meant to correspond to the Value-at-Risk of basic own funds subject to a confidence level of 99.5% over a one-year period, i.e the movement in the Solvency II balance sheet between T(0) and T(1). As such, in terms of the contribution to the change in basic own funds, the risk associated with the business included under the $FP_{(future,s)}$ term should relate to the extent to which the valuation of the insurance obligations arising from this business can vary when setting the premium provision of the Solvency II balance sheet at T(1).
- In particular, we do not believe that adverse claims experience for business earned between T(0) and T(1) would lead insurance and reinsurance undertakings to increase the premium provision at T(1) to the same extent, as this would imply 100% correlation of claims experience between two years (or more, in the case of multi-year policies).
- If the standard parameters are to be the same between the P and FP volume measures, then the definition of the FP volume measures should be adjusted to recognise the above.
- We agree that there is a risk that the business written between T(0) and T(1) and earned after T(1) is underpriced. However, this assumes that the business is written before the adverse claims experience between T(0) and T(1) has been observed and so has not been taken into account in the pricing. As such, there should be some allowance for the timing of when the business is written to recognise the likelihood of underpricing.
- In the case of our example, if the policies incepting at T(1) are bound at $T(\frac{11}{12})$, then there is a

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	<p>good chance that most of the claims experience between T(0) and T(1) will have already been observed by this stage.</p> <ul style="list-style-type: none"> If the definition of the $FP_{(future,s)}$ term is to be changed to only exclude the premiums to be earned during the following 12 months, then a simple adjustment to allow for the likelihood of underpricing would be to multiply the $FP_{(future,s)}$ term by $1 - T(R)$ where $T(R)$ = initial recognition date. In the case of our example, it would become $120 \times (1 - \frac{11}{12}) = 10$ which is the same result as under the current definition. 	
Q5.2		
Q5.3	<p>We provide management services to a number of mutual insurance companies that write annual policies, all coinciding with the company's financial year. The policies are typically renewed one month prior to their inception date.</p> <p>Let T(t) represent the date, with t in years from the SCR calculation date at the company's financial year end. Assume that the premium earned in each year is 120.</p> <p>Then under the current definitions of the volume measure for premium risk and ignoring discounting:</p> <p>P_s = estimate of premiums to be earned between T(0) and T(1) = 120</p> <p>$P_{(last,s)}$ = premiums earned between T(-1) and T(0) = 120</p> <p>$FP_{(existing,s)}$ = 0 (as the company writes annual policies)</p> <p>$FP_{(future,s)}$ = estimate of premiums to be earned for contracts bound between T(0) and T(1) excluding premiums to be earned during the 12 months after the initial recognition date = $120 \times \frac{1}{12}$ (as the annual policies incepting at T(1) are bound at T($\frac{11}{12}$) so the premiums to be earned between T($\frac{11}{12}$) and T(1 $\frac{11}{12}$) are excluded, leaving only the premiums to be earned</p>	

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	<p>between $T(1^{11}/_{12})$ and $T(2)$ = 10</p> <p>$V_{(prem,s)} = \max(P_s; P_{(last,s)}) + FP_{(existing,s)} + FP_{(future,s)}$ = $\max(120; 120) + 0 + 10$ = 130</p> <p>If the definition of $FP_{(future,s)}$ is changed to only exclude the premiums to be earned during the following 12 months (i.e. between $T(0)$ and $T(1)$), then the results become:</p> <p>$FP_{(future,s)} = 120$ (as the annual policies are incepting at $T(1)$ so none of the premiums will be earned between $T(0)$ and $T(1)$)</p> <p>$V_{(prem,s)} = \max(120; 120) + 0 + 120$ = 240</p> <p>i.e. the volume measure almost doubles. This would significantly increase the company's SCR.</p> <p>For the companies that we manage, the extent of the increase will depend on the contribution of premium risk to the company's overall SCR. Based on the SCR results last year, the SCR can increase by over 20% in the most extreme case.</p>	
Q5.4		
Q5.5	<p>Let $T(t)$ represent the date, with t in years from the SCR calculation date at the undertaking's financial year end.</p> <p>The $\max(P_s; P_{(last,s)})$ in the definition of $V_{(prem,s)}$ can lead to various problems:</p> <ol style="list-style-type: none"> 1. The main purpose of the $P_{(last,s)}$ term appears to be to address situations where the undertaking reduces premium rates. However, under such situations, P_s based on the 	

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reduced rates is not necessarily inappropriate as the volume measure for business earned between T(0) and T(1), for example in a hard market.

2. There are other situations where P_s would naturally be lower than $P_{(last,s)}$. An obvious example would be where an undertaking purchases more reinsurance for the business earned between T(0) and T(1). By having to use $P_{(last,s)}$ as the volume measure, this means that no credit is given for the reduction in the retained risk, resulting in premium risk and hence the SCR being overstated.
3. There are also situations where the undertaking simply expects to earn less business between T(0) and T(1) than between T(-1) to T(0). In such situations, the $P_{(last,s)}$ term just serves to overstate premium risk and hence the SCR.
4. The problem observed in point 3 is also seen in the calculation of the risk margin when considering how premium risk runs off over time and the $FP_{(existing,s)}$ term at T(0) is non-zero and less than P_s . For example, suppose we have $P_{(last,s)} = 120$, $P_s = 120$ and $FP_{(existing,s)} = 20$ at T(0) ($FP_{(future,s)} = 0$ since no new business is written when calculating the risk margin). Then $V_{(prem,s)} = \max(120;120) + 20 = 140$ at T(0) and $\max(120;20) + 0 = 120$ at T(1). This would clearly overstate premium risk and hence the SCR at T(1).
5. It also affects the calculation of the risk-mitigating effect of reinsurances when determining the hypothetical underwriting risk capital requirement assuming the reinsurance arrangement did not exist. In particular, it is possible to have situations (such as in point 2 above) where the actual net underwriting risk capital requirement would be based on $P_{(last,s)}$ but the hypothetical gross underwriting risk capital requirement would be based on P_s , or vice-versa. This is clearly inconsistent, and in any case, given that the risk-mitigating effect of reinsurances in respect of premium risk relates to reinsurance arrangements after T(0), it does not make sense to use $P_{(last,s)}$ in this calculation.

Based on the above, we believe that the $P_{(last,s)}$ term should be removed from the definition of the

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	volume measure for premium risk.	
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Q12.1

The time horizon for the calculation is not clear.

Let $T(t)$ represent the date, with t in years from the SCR calculation date at the undertaking's financial year end.

Under Article 192 (2) of the Solvency II Delegated Regulation, the loss-given-default on a reinsurance arrangement is based on (i) the best estimate of amounts recoverable from the reinsurance arrangement; and (ii) the risk-mitigating effect of the reinsurance arrangement. This can be interpreted as being (i) the best estimate of amounts recoverable recognised on the undertaking's Solvency II balance sheet at $T(0)$; and (ii) the difference between the hypothetical and actual underwriting risk capital requirements in full.

However, under the Solvency II Directive, the SCR is meant to correspond to the Value-at-Risk of basic own funds subject to a confidence level of 99.5% over a one-year period, i.e the movement in the Solvency II balance sheet between $T(0)$ and $T(1)$. As such, we believe that the counterparty default risk calculation should be limited to exposures between $T(0)$ and $T(1)$.

For example, suppose the undertaking has bound a two-year insurance contract at $T(0)$, and purchases single-year reinsurance arrangements, with the reinsurance arrangement covering the period $T(0)$ to $T(1)$ already placed. The undertaking also assumes that it will purchase reinsurance in the future and so recognises the reinsurance recoverables for the exposure between $T(1)$ and $T(2)$ on its Solvency II balance sheet at $T(0)$ (as permitted under Guideline 78 of EIOPA's 'Guidelines on the valuation of technical provisions').

Under the situation above, as the reinsurance arrangement covering the exposure between $T(1)$ and $T(2)$ has yet to be placed, it is not possible for counterparty defaults to occur in respect of this arrangement over the one-year period from $T(0)$ to $T(1)$. As such, the loss-given-default should be limited to:

Q12.2

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	<p>(i) the best estimate of amounts recoverable for the reinsurance arrangement covering the exposure between T(0) and T(1) only, i.e. excluding the amounts recoverable for the exposure between T(1) and T(2); and</p> <p>(ii) the risk-mitigating effect of the reinsurance arrangement covering the exposure between T(0) and T(1) only, i.e. the underwriting risk capital requirements should be calculated with the $FP_{(existing,s)}$ and $FP_{(future,s)}$ terms excluded from the premium risk volume measure.</p> <p>Even in the event that the undertaking assumes that the reinsurance arrangement covering the exposure between T(1) and T(2) uses the same reinsurers as for the reinsurance arrangement covering the exposure between T(0) and T(1) and these reinsurers default over the one-year period from T(0) to T(1), clearly the undertaking can place the new reinsurance arrangement at T(1) with different reinsurers.</p>	
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