INFORMATION NOTE: CONSIDERATIONS ON RETRENCHMENT RISK IN THE SCR STANDARDISED FORMULA

Classification

This document is classified as an Information Note.

Background

This information note summarises the main considerations highlighted through a survey that was completed by key insurers with reasonable retrenchment risk exposure. The survey collected qualitative data on the retrenchment claims experience, assumptions and risks faced by the respondents.

This document is intended to provide some additional considerations around retrenchment risk, for members of ASSA (members), when:

- Evaluating the appropriateness of the standardised formula;
- Assessing risk profile and scenarios as part of an Own Risk and Solvency Assessment (ORSA);
- Incorporating retrenchment risk into other internal models and assessments.

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1 INTRODUCTION

1.1 Background to retrenchment risk within the FSI standardised formula

Currently the standardised formula specifies a long-term 50% relative and permanent increase in the retrenchment rate in determining the capital charge for retrenchment risk under the Solvency Capital Requirement ("SCR").

The retrenchment risk calibration in the SCR was set very approximately, without reference to stresses from other jurisdictions or industry data. Solvency II does not have an explicit retrenchment or "loss of income" stress within the life underwriting risk module. Additionally, no industry data was gathered or analysed to determine the stress level.

Retrenchment risk is not a material risk for all insurance industry players. However, it can be material for some insurers, such as those selling credit life products or risk products allowing for retrenchment (and related) cover.

The Solvency Assessment and Management Steering Committee approved Position Paper 108 v4 on Retrenchment Risk in March 2015. This document includes the following statement:

> *"The task group notes that, in this regard, those insurers for whom retrenchment is a significant risk should address this via a partial internal model or the ORSA."*

The Position Paper thus recognised that the standardised formula for retrenchment was not robustly calibrated and additional work may be necessary for insurers with material retrenchment risk.

The Position Paper also summarised some of the feedback from the Quantitative Impact Studies ("QIS") on the proposed parameterisation of the retrenchment risk shocks as follows:

> *All insurers who raised concerns on the calculation were concerned that the calculation was understating the risk. In particular, the following points were raised:*
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> - *The calculation did not allow for either concentration or catastrophe risk.*
> - *The calculation did not reflect the cyclicality of retrenchment risk. There was a view that an increase in the retrenchment rates would be more severe than the parameters suggested in SA QIS2, but would last for a shorter time period.*

Despite these concerns around the 50% retrenchment stress parameter, no changes were proposed and the stress level has remained unchanged.

1.2 Background to this note

The SAM Phase II subcommittee of the ASSA Life Assurance Committee established a working group to evaluate the appropriateness of the standardised formula, with the aim of providing additional support to members and/or input to the regulator on how to think about the level and nature of a more refined retrenchment risk stress.

Getting access to sufficient data from individual insurers to perform a detailed investigation of experience proved difficult.

In the absence of detailed data, a survey of key insurers was conducted, covering qualitative aspects of retrenchment claims experience, assumptions and risks.

While the focus has been on "retrenchment", given the experiences during the national lock-down because of the COVID-19 pandemic, "partial or total loss of income" and/or "inability to earn an income" are also potential claim events and these have also been considered and are included whenever "retrenchment" is mentioned in this paper.

1.3 Limitations

The following limitations apply to this information note:

- The information note considers different ways of allowing for Retrenchment Risk shocks in the calculation of capital requirements. The information could be used to assess the capital requirements within the context of the standardised formula Solvency Capital Requirement ("SCR") as well as in the context of an approved internal model or economic capital model.
- This information note only considers Retrenchment Risk within the South African context. For other jurisdictions it is thus worth considering the local retrenchment experience and the economic climate.
- The conclusions drawn in this information note are based on a limited number of respondents which results in reduced data credibility.
- The underlying data used to draw conclusions in this information note are not robust and are influenced by subjective responses collected in the survey.
- The survey was sent out in the middle of the COVID-19 pandemic, after the national lock-down, when the worst initial retrenchment shocks were experienced in South Africa and around the time when retrenchment risk levels were returning to pre-lockdown levels. This may also add to the subjectivity of the data.
- The survey and therefore, this information note, do not consider the variability around duration of retrenchment. This is an additional source of risk.

2 RETRENCHMENT RISK SURVEY

2.1 Survey methodology and limitations

The survey was sent to 20 insurers expected to have reasonable exposure to retrenchment risk, operating either as bancassurers or traditional insurers. 17 anonymous responses were recorded covering a broad representation of the industry. Of the 17 respondents, 4 respondents did not have sufficient retrenchment risk to constructively contribute to the survey and were removed from the analysis. Of the remaining 13 respondents, 4 had inadequate, incomplete or contradictory responses.

As a result, only 9 responses were used to draw the observations contained in this note. References to "respondents" in the rest of this note relate to these 9 responses only.

All the respondents are exposed to retrenchment risk through selling Credit Life, whilst 4 are also exposed through selling other Risk products. The contract boundaries of the products sold by the respondents ranged across all durations (less than 1 year to longer than 10 years), but at least 8 out of the 9 respondents sell business with a contract boundary of less than 1 year.

Most of the respondents use the definition of 'retrenchment', with 3 respondents using this definition exclusively. Half of the respondents use 'total loss of income' as the definition of the risk event, with no respondents using this definition exclusively, but always in conjunction with another definition. This is true for 'partial loss of income' risks as well.

2.2 Main observations from the survey

2.2.1 Appropriateness of standardised formula and updating guidance

Most respondents indicated that the standardised formula does not adequately cover the retrenchment risk with at least one respondent quantifying their retrenchment risk differently from the standardised formula when assessing risks to earnings and solvency as part of the ORSA and other risk management processes.

8 out of the 9 the respondents indicated that they would welcome guidance from ASSA on how to better measure their retrenchment risk in order to improve the quality of work and to align to industry practice. All the respondents said they would support an update to the Financial Soundness Standard for Insurers ("FSI") to refine the retrenchment risk calibration.

2.2.2 Views on appropriate structure of retrenchment incidence rate stresses

There were four retrenchment risk incident rate stresses considered and presented to the survey respondents, to assess their view of what the appropriate stresses are:

- A 'catastrophe' style stress defined as an absolute increase in the short-term incidence rates
- A 'catastrophe' style stress defined as a relative increase in the short-term incidence rates
- An absolute increase in the long-term incidence rates
- A relative increase in the long-term incidence rates

The responses indicated a clear preference for a combination of a short-term and a long-term stress as appropriate, with both having a greater support for relative stresses (as opposed to absolute increases).

All respondents believed that there should be a short-term increase in incidence rates.
Just over half of respondents believe that 12 months is an appropriate term for a short-term increase. A third believe a 6-month term is appropriate.

The survey did not address stresses around the average duration of retrenchment claims. This is another source of variability, with effectively a zero stress under the current standardised formula.

2.2.3 Views on appropriate level of retrenchment incidence rate stresses

When asked to provide a view of the appropriate percentage shock, different views on the extent of short term versus long term shocks emerged.

All the respondents believe that the standardised formula stress is too low and the retrenchment risk shock, overall, needs to be increased. More specifically, the following observations were made:

- The relative short-term incident rate shock should be between 150% and 500% (responses were evenly distributed).
- The relative long-term incidence rate shock should be between 25% and 150%, with the most votes for the (current) 50% relative increase.
- This means that:
    - About one third of the respondents believe the current 50% relative long-term increase to be appropriate, but that there should be an additional relative short-term increase.

- Another third of the respondents believe that the relative long-term increase should be greater than 50% (up to 150%) but should be combined with a lower relative short-term increase.
- The final third believe the long-term stress should be lower than the current 50%, at a level of 25%, but combined with an additional short-term stress.

- Those respondents who believe an absolute increase is appropriate, suggested an increase between 2.5% and 7% in the short-term only (responses were evenly distributed).

2.3 Conclusion

Given the survey results and the above analysis and interpretation, a definitive proposal, to the Prudential Authority, to adjust the FSI to allow for short-term and long-term shocks is not possible.

However, based on the evidence and information collected and summarised in this note, primarily from:

- Industry comments and concerns arising out of the QIS process and Position Paper 108; and
- the views summarised here from the limited survey conducted in 2021

it can be concluded that:

1. The calibration of the original retrenchment stress was recognised by the industry as not being universally appropriate and would require further insurer-specific consideration.
    a. It was not derived from a robust Solvency II development process as some other parameters were.
    b. No experience data was analysed to determine the variability in experience.
2. The survey results support the idea that the standardised formula is unlikely to be appropriate on average, let alone for any individual insurer.
3. The consensus view was that the current standardised formula stress is too low.
4. There is therefore an elevated risk that the standardised calibration is not appropriate in level or structure. If Insurers have material retrenchment risk, it may not be appropriate to rely merely on the standardised formula being correct across the industry when assessing its suitability.
5. It may be appropriate to consider both:
    a. a short term catastrophe-type stress of between 6 and 12 months; as well as
    b. a permanent change in retrenchment level risk
6. It may also be appropriate to consider variability in the duration of retrenchment claims, where this is applicable.
7. When considering retrenchment risk, consideration of the completeness of relevant experience and differences between definitions of inability to earn an income, partial or total loss of income, and retrenchment may need to be considered.
8. If Insurers have material retrenchment risk exposure, some of the results of the survey summarised in this note could be used to complement their own experience and views on their risk profile, stress and scenario testing, opinion on the standardised formula and internal assessments of capital as part of the ORSA or otherwise.