AAE Risk Management Committee Position Paper on EIOPA Report and long-term guarantees measures and measure on equity risk 2017

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Introduction

The long-term guarantees (LTG) measures were introduced in the Solvency II Directive through the Omnibus II Directive in order to ensure an appropriate treatment of insurance products that include long-term guarantees. The measures on equity risk should ensure an appropriate measure of equity risk in setting the capital requirement for insurance and reinsurance undertakings in relation to the risks arising from changes in the level of equity prices.

The Solvency II Directive requires a review of the LTG measures and the measures on equity risk until 1 January 2021. As a preparation to this review, EIOPA annually reports on the impact of the application of the LTG measures and the measures on equity risk to the European Parliament, the Council and the Commission. For 2017, EIOPA published their 2nd report on this topic[1] 20 December 2017 and included several detailed analysis on the aforementioned measures:

Name of Measure	Articles in Directive
Extrapolation of the risk-free interest rates	77a
Matching adjustment	77b, 77c
Volatility adjustment	77d
Symmetric adjustment mechanism to the equity risk charge	106
Extension of the recovery period	138(4)
Duration-based equity risk sub-module	304
Transitional on the risk-free rate	308c
Transitional on technical provisions	308d

In order to assess the impact of the extrapolation of risk-free interest rates and of the symmetric adjustment mechanism to the equity risk charge EIOPA carried out an information request to insurance and reinsurance undertakings. With regard to the extrapolation, undertakings assessed the impact of three scenarios to change parameters of the extrapolation:

Scenario 1: Increase of the LLP for the euro from 20 to 30 years. For currencies other than the euro, the risk-free interest rates are unchanged.

Scenario 2: Increase of the minimum convergence point from 60 to 90 years for all currencies except the Swedish krona.13 For the Swedish krona the convergence point changes from 20 years to 50 years

Scenario 3: Decrease of the UFR for all currencies by 100 basis points

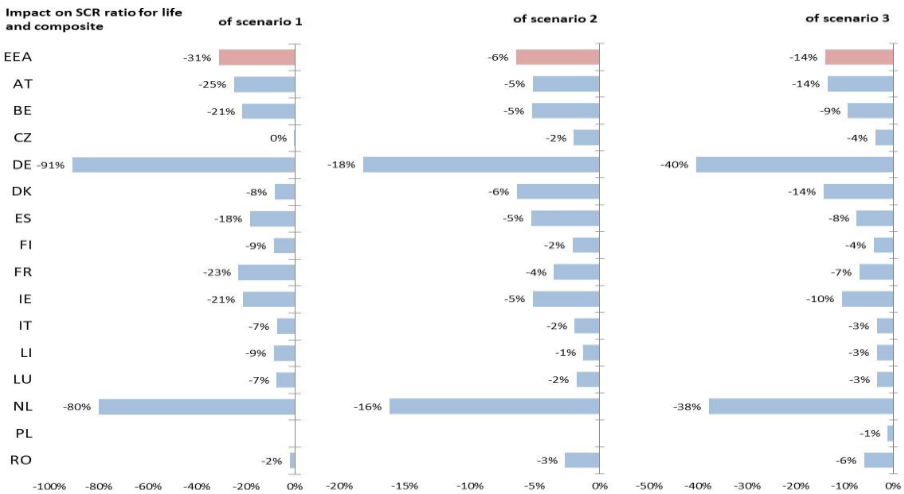
[1] https://eiopa.europa.eu/Publications/Reports/2017-12-20%20LTG%20Report%202017.pdf

Overview of results

The scenario that turned out to be most severe on average was the increase of the starting point of the extrapolation for the Euro from 20 to 30 years. In this scenario, undertakings with long-term cash-flows reported a reduction of the Solvency Capital Requirement ratio by rounded 28 percentage points. The following observations are also notable:

- Removing these measures would decrease the amount of eligible own funds to cover the Solvency Capital Requirement by €164bn and increase the Solvency Capital Requirement by €73bn.
- Where insurance or reinsurance undertakings depend on the transitional measures to comply with the Solvency Capital Requirement, national supervisory authorities are generally confident that undertakings will be able to reduce the dependency on transitional measures, to the point of no dependency by 1 January 2032.
- Without consideration of UK undertakings, the total number of undertakings not complying with the SCR without the transitional measures at EEA level decreased by 5 from 35 undertakings at the beginning of 2016, to 30 undertakings at the end of the year
- The missing amount of eligible own funds to comply with the SCR without the transitional measures decreased by €2.48bn, from €5.26bn at the beginning of 2016 to €2.78bn at the end of the year.

Long-term guarantees are included in many types of insurance products and widely spread among European countries, with large differences between the relative importance of long-term guarantees products in each market. The most significant line of business with long-term guarantees products in the majority of countries is traditional life insurance products with profit participation. Depending on the relevance of these products in the respective markets, especially Germany and The Netherlands show a strong effect for all three scenarios:



Assessment of AAE Risk Management Committee

Commented [dLD(-B1]: I fully agree with the assessment but are we sure at this stage that those LTG reports will be the only input for LTG review? We might otherwise need to slightly rephrase

This report shows only a very high level and aggregated overview of effects. Even there we observe a vast difference of behaviour in different countries and lines of business. When reporting an effect of 28 percent points of the most extreme scenario on aggregate, we see on a more granular view that for Germany that means a decrease by 91 percent points and for The Netherlands by 80 percent points. We expect that this will be even more extreme when looking into effects on single companies.

Conclusion 1: The results are too aggregated while some review has already started

It is not sufficient to limit the discussion to aggregate results. Changes of the parameters of LTG measures will have a leveraged effect on single countries with high exposures in long-term guarantee products and this has to be considered when reviewing the measures.

Especially the risk free rate term structure is a core parameter that significantly effects the risk assessment of long-term guarantee products. Changes in the Solvency II framework have already gradually affected this highly relevant parameter:

- 2017: EIOPA developed a methodology to define the UFR leading to a stepwise reduction by 0.15% starting 2018 while CoC factor remains unchanged at 6%
- 2018: SCR-Review: Recalibration of interest rate risk module in standard formula (EIOPA's own initiative)
- 2018: EIOPA announced publication of a series of papers concerning systemic risk in insurance.
  Goal: Enhancement of the solvency regime by embedding the appropriate macro prudential tools into it

Hence, the review of the LTG measures and measures on equity risk until 1 January 2021 are not based on the original assumptions and the original framework as decided via the Omnibus II Directive but will already implicitly be designed on a more restrictive and conservative framework.

Conclusion 2: Make changes more predictable and manageable

To enable a manageable framework for the highly exposed undertakings in long-term guarantee products it has to be ensured that a transparent and open discussion on increasing requirements instead of a steady and unpredictable hardening is provided to all stakeholders.

Most of the analysis so far has been based on the assessment of separate and solely applied scenarios. It is not well understood how merging these scenarios will affect the total OF and SCR of highly exposed undertakings. It has to be further analysed, whether some of these scenarios would not only add up but produce even an leveraged effect on the solvency requirements.

Secondly, we observe that the SCR is heavily depending on the current market environment and asset allocation for such companies. Test done in the current environment might lead to completely other effects in another state of the economy.

Conclusion 3: Perform a comprehensive assessment

The analysis done so far is not only too high level. It is required to perform a more granular examination of effects under various capital market environments and possible changes of the insurance portfolios.

Based on the currently available reports and with the limited knowledge on the behaviour of the models of single undertakings in various capital market environments, it would be dangerous for highly exposed undertakings to restrict the currently existing LTG measures. A more detailed analysis – perhaps similar to the Qualitative Impact Studies (QIS) as performed before the implementation of Solvency II – has to be started to enable a well prepared and educated decision on any changes of the LTG measures.

Next to a quantitative assessment, it is also important to consider second order effects such as consumers' behaviour, growth and international competition. To support the CMU and sustainable objectives of the EC, insurers need an appropriate framework to offer long-term coverages before being long-term investors.