



# Review of the Solvency II Delegated Act

Focus on long-term guarantees (LTG) measures

*EGBPI meeting - 3 February 2022*

# Background

- During the Council working party (CWP) meeting of 31 January 2022 dedicated to LTG measures, many delegations asked for more clarity of Commission's intentions on the related topics included in the Commission Delegated Regulation (EU) 2015/35
- This document aims at collecting experts' feedback on the key areas for amendments to that Delegated Regulation on long-term guarantees measures, as outlined in the [Communication from the Commission on the Solvency II review](#) and the Commission services' non-paper of 8 November 2021.
- Based on those feedback, the Commission services intend to hold another EGBPI meeting on 24 February 2022 in order to discuss in greater details possible ways forward on the review of Level 2 in relation to LTG measures.
- This document does not touch upon the following topics:
  - The symmetric adjustment to equity risk capital charge, as this topic was already raised during the CWP on Monday
  - The design of the long-term equity asset class, which requires a dedicated discussion.

# Agenda

- Volatility adjustment
- Matching adjustment
- Extrapolation
- Interest rate risk (standard formula)
- Risk margin

# Volatility adjustment

# Issues not addressed today as already discussed during the CWP meeting

## Illiquidity factor

- DG FISMA understands from the last CWP meeting that at this stage, a majority of Member States support the COM proposal not to include an illiquidity ratio
- For the time being, this is the working assumption for today's meeting,

## Quality overshooting factor

- DG FISMA understands from the last CWP meeting that at this stage, a majority of Member States support the COM proposal not to include a quality overshooting ratio
- For the time being, this is the working assumption for today's meeting,

## The level of the general application ratio

- DG FISMA understands that Member States want to keep the level of the general application ratio in the Level 1, in line with the Commission's proposal.
- Some Member States also underlined that the discussion on the level of the general application ratio has to be held in conjunction with the discussion on the illiquidity factor
- For the time being, the working assumption is that the general application ratio is 85%

# Key possible amendments to the Delegated Regulation on the Volatility Adjustment

Change in the methodology to derive risk correction in order to better capture all the risks inherent in the spread and ensure risk sensitivity

- For EEA government bonds:  $RC = 30\% \cdot \min(S^+, LTAS^+) + 20\% \cdot \max(S^+ - LTAS^+, 0)$
- For other fixed-income securities:  $RC = 50\% \cdot \min(S^+, LTAS^+) + 40\% \cdot \max(S^+ - LTAS^+, 0)$

Change in the representative portfolio, so that the weights of fixed income instruments sum to 1

Amendment to the formula calculation of the spread in Article 50 of the Delegated Regulation

- For each currency and country :  $S = w_{gov} \cdot \max(S_{gov}, 0) + w_{corp} \cdot \max(S_{corp}, 0)$

Specification of the credit spread sensitivity ratio in line with EIOPA's advice

- For currency c,  $CSSR_c : \max \left\{ \min \left\{ \frac{PVBP(\text{Market value of fixed income investments in currency } c)}{PVBP(\text{Best estimate } i \text{ in currency } c)} \right\} \right\}$

# Overview of experts' written feedback on possible changes to the Volatility Adjustment

Definition of CSSR, change in the weights and in the formula in Art. 50

- Support or explicit non-objection from BE, BG, ES, IT, NL, PL, SE, SK

Change to risk correction

- Support: BE, DE, ES
- Explicit non-objection: PL, SE, SK
- Disagreement: IT, NL, PT

# Questions to experts on potential changes to the Delegated Regulation on Volatility Adjustment

- **Question 1:** Do experts have any concerns with regard to the following possible changes to the rules governing the volatility adjustment?
  - Specification of the credit spread sensitivity ratio
  - Change to the way of computing weights of fixed-income securities in the reference portfolio
  - Change to the definition of the spread in Article 50 of the Delegated regulation
- **Question 2:** In relation to the risk-corrected spread, what is experts' preferred option:
  - **Option 1:** follow EIOPA's proposed new methodology which would improve risk sensitivity
  - **Option 2:** do not amend the methodology to derive risk correction
  - **Option 3:** amend the methodology to derive risk correction, but in a different manner from EIOPA's Opinion (please specify)

# Matching adjustment

# Key possible amendments to the Delegated Regulation on the Matching adjustment

## Allowance for diversification benefits in the calculation of the SCR between matching adjustment portfolios and the rest of the undertaking, as advised by EIOPA

- Concerns Articles 216, 217 and 234 of the Delegated Regulation

## Clarification in a new article of the eligibility of restructured assets for the matching adjustment, in line with EIOPA's Opinion

- For assets the cash flows of which are dependent on the performance of other underlying financial assets, the following criteria could be considered
  - the underlying assets provide a sufficiently fixed level of income;
  - the restructured asset cash flows are supported by loss absorbency features such that those cash flows are sufficiently fixed in term and will remain so even as operating conditions change;
  - where the underlying assets include financial guarantees, those guarantees do not increase the matching adjustment;
  - the undertaking is able to properly identify, measure, monitor, manage, control and report the underlying risks.

# Question to experts on potential changes to the Delegated Regulation on matching adjustment

- **Question 3** : Do experts have any concerns with regard to the following possible changes to the rules governing the matching adjustment?
  - Allowance for diversification benefits in the calculation of the SCR between matching adjustment portfolios and the rest of the undertaking, as advised by EIOPA
  - Clarification in a new article of the eligibility of restructured assets for the matching adjustment, in line with EIOPA's Opinion

	Overview of experts' written feedback on possible changes to matching adjustment
Support	BG, ES, NL
Explicit non-objection	PL, PT, SE, SK
Addition remarks	<ul style="list-style-type: none"><li>• ES: need to also remove own fund restrictions in relation to MA</li><li>• NL : the requirements should also be allowed to be fulfilled for a portfolio of assets instead of applying requirements at the level of individual assets.</li></ul>

# Extrapolation

The following slides rely on the working assumption that the balance between level 1 and level 2 is preserved, in line with the Commission's proposal.

# Key possible amendments to the Delegated Regulation on extrapolation

## Specification of the criteria for the determination of the first smoothing point

- For the 'residual volume criterion', the percentage referred to in the proposed Article 77a(1)(b) of the Solvency II Directive would be **6%**.
- Remarks:
  - Combined with the DLT assessment, this would have always resulted in a FSP of 20 years for the Euro between 2016 and 2020
  - In accordance with proposed Article 77e(4), the FSP cannot change before evidence suggests a different value for two consecutive years

## Convergence parameter (alpha)

- **Steady-state value:** In view of the proposed amendments to Article 77a(2) of the Solvency II Directive, the convergence parameter would be set at 10% as of 1 January 2032 (40% for the Swedish Krona), in line with EIOPA's advice.
- **On the first day of application of the amending Directive,** alpha would be such that the new risk free curve is sufficiently similar to the one derived from the Smith-Wilson technique. A value of 20% would be used (in line with EIOPA's advice) unless evidence indicates that that value would not ensure the required similarity.
- **Phasing in:** From the date of entry into application to 1 January 2032, the alpha parameter would linearly decrease every year. No phasing-in would apply for the Swedish Krona.

## Formula to derive extrapolated rates

- $f_{FSP, FSP+h} = \ln(1 + UFR) + (LLFR - \ln(1 + UFR)) * \frac{1 - e^{-\alpha h}}{\alpha h}$ 
  - FSP denotes the first smoothing point ; UFR is the ultimate forward rate ;  $\alpha$  is the convergence parameter.
  - $h$  denotes the maturity for which the forward rate is determined beyond the first smoothing point (FSP),
- LLFR is the last liquid forward rate, determined as a weighted average of forward rates (corresponding to DLT maturities) before and after the FSP where the weights depend on the liquidity of the respective rates according to the notional amount at a particular maturity
  - Where a VA is applied, that adjustment would be applied to the last forward rate before the FSP for the purpose of determining the LLFR.

# Questions to experts on potential changes to the Delegated Regulation on extrapolation

- **Question 4** : Do experts have any concerns with regard to following possible changes to the rules governing extrapolation?
  - The percentage for the 'residual volume criterion' used to derive the first smoothing point
  - The values of the convergence parameter, including the phasing-in until 1 January 2032
- **Question 5** : Do experts have any concerns with regard to the possible formula to calculate extrapolated rates?

Overview of experts' written feedback on potential amendments to extrapolation	
Support	BG, ES, IT, NL
Explicit non-objection	PT, SK
Other	SE: support, but the formula for deriving extrapolated rates should not use logarithmic figures (which is due to the notation with continuously compounded rates). Alternative formula: $f_{FSP, FSP+h} = UFR + (LLFR - UFR) * \frac{1 - e^{-\alpha h}}{\alpha h}$

# Interest rate risk (standard formula)

*NB: The following slides rely on the working assumption that the phasing-in schedule of the change to interest rate risk would be defined in Level 2*

# Key possible amendments to the Delegated Regulation on interest rate risk

## Follow EIOPA's advice to derive interest rates up to the first smoothing point of the interest rate term structure, including the introduction of a floor to negative rates

- $r_t^{up}(m) = r_t(m) * (1 + s_m^{up}(\theta_m)) + b_m^{up}$       and       $r_t^{down}(m) = r_t(m) * (1 + s_m^{down}(\theta_m)) + b_m^{down}$
- Floor to downward interest rate risk : stressed rates cannot go below -1.25%

## Deviate from EIOPA's advice with regard to stressed rates beyond the first smoothing point

- Stressed interest rates beyond the FSP would be extrapolated, by assuming that the UFR is increased or decreased by 15 basis points for the upward and downward stressed scenarios.
- Would ensure consistency between the interest rate risk free term structure under normal conditions and that under stress.
- Would also reflect the lower volatility of long-term rates caused by the extrapolation method

## 5-year phasing-in in line with EIOPA's Opinion

- Possible additional issue for the derivation of extrapolated rates: which value of the convergence parameter should apply during the phasing-in of the extrapolation method until 2032?
  - EIOPA's impact assessment (used in the COM impact assessment) assumed alpha of 10% (40% for the Swedish Krona)

## Allowance for diversification of risks between currencies? (*not covered in the Commission's communication*)

- Under current rules, the loss in basic own funds stemming from a shock on interest rates in a given currency cannot be offset by a gain stemming from a change in interest rates denominated in another currency

# Overview of experts' written feedback on possible changes to interest rate risk

Overview of experts' written feedback on interest rate risk	Treatment of short-term rates, including floor and phasing in	Deviation from EIOPA's opinion on long-term rates	Recognition of diversification between currencies
Support	BG, DE <sup>(*)</sup>	BG, CZ	
Explicit non-objection	HU <sup>(**)</sup> , SE, SK	HU, SE, SK	
Disagreement or doubts	CZ: volatility should be assumed lower for negative rates. In addition, a ceiling should be introduced for upward shock	DE, PT	HU

<sup>(\*)</sup> But the phasing-in should be part of the phasing-in plans of Article 308e of the Solvency II Directive

<sup>(\*\*)</sup> But need for more clarity as to whether the transitional is voluntary or mandatory.

# Questions to experts on potential changes to the Delegated Regulation on interest rate risk

- **Question 6:** Do experts have any concerns regarding the following potential amendments to rules on interest rate risk?
  - Follow EIOPA's Opinion with regard to the computation of stressed interest rates up to the FSP
  - Introduction of a floor of -1.25% in line with EIOPA's Opinion
  - 5-year phasing-in of changes
- **Question 7:** Regarding the phasing-in, what is experts' view on the following two questions:
  - Should the phasing-in be mandatory or optional (i.e. could an insurer apply the steady-state new interest rate risk from day 1)?
  - Should the capital relief stemming from the phasing-in be i) calculated and reported to NSA and/or ii) publicly disclosed?
- **Question 8:** With regard to stressed interest rates for maturities beyond the FSP, what is experts' preferred option :
  - **Option 1:** Extrapolate rates, as described in the Commission's Communication
    - If so, please indicate whether you agree with the use of a convergence parameter of 10% (except for SEK, where a parameter of 40% would be used).
  - **Option 2:** Do not deviate from EIOPA's Opinion and apply the same methodology as for short-term rates
- **Question 9:** Should diversification be allowed between different currencies within the interest rate risk submodule? If so, how should such diversification be accounted for?

# Risk margin

# Key possible amendments to the Delegated Regulation on risk margin

**Reduce the volatility of the risk margin by introducing a lambda factor**

- Value of the lambda factor : 0.975 in line with EIOPA's Opinion

**No floor to the reduction effect of the lambda on projected SCRs**

- Deviation from EIOPA's Opinion which was recommending a floor of 50%

**Reduce the cost of capital rate from 6% to 5%**

# Questions to experts on potential changes to the Delegated Regulation on risk margin

- **Question 10:** With regard to the lambda approach, what is experts' preferred option:
  - **Option 1:** lambda of 0.975 and no floor – in line with Commission's Communication
  - **Option 2:** lambda of 0.975 and a 50% floor – in line with EIOPA's Opinion
  - **Option 3:** other – please specify
- **Question 11:** With regard to the cost-of-capital rate, what is experts' preferred option:
  - **Option 1:** cost of capital of 5% - in line with Commission's Communication
  - **Option 2:** lambda of 6% - in line with EIOPA's Opinion
  - **Option 3:** other – please specify

Overview of experts' written feedback on risk margin	Removal of the floor to the effect of the lambda factor	Decrease in the cost of capital
Support	BG, ES, NL	BG, ES, NL
Explicit non-objection	PL, SE	DE, PL, SE
Disagreement / doubt	BE, CZ, IT, PT	CZ, HU, IT, PT, SK

# Thank you



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