Extrapolation of risk-free interest rates

- **Industry supports Option 1: No change**
  - The concerns identified by EIOPA are not valid and/or material enough to justify any changes
  - Industry does not therefore support EIOPA's proposed changes to the extrapolation methodology or parameters used to derive the risk-free curve
- **Insurers must be able to match cashflows in liquid part of curve with bonds – this is not possible if LLP is extended**
  - EIOPA's analysis shows that market conditions have not changed significantly since 2014. It shows that the maximum EUR LLP should be:
    - 15 years according to Matching criterion.
    - 22 years according to Residual volume criterion.
  - No information on the DLT assessment of Euro bond market is provided

Extrapolation of risk-free interest rates

- **Stability of extrapolation methodology and parameters is important**
  - The assets and liabilities of the insurance industry are generally well matched
  - Changing methodology and parameters will have a large and disruptive impact on inter alia capital management and hedging (potentially disrupting capital markets as insurers adjust hedging strategies)
  - Proposed changes are likely to create additional downward pressure on the medium/long-dated interest rates
  - There is no evidence that the possible benefits of alternative approaches are sufficient to justify the disruption and cost of the implementation of such an approach

- **Industry strongly objects to introduction of NSA powers to limit capital distributions based on an ultra-conservative, "shadow" SCR†**
  - This sets requirements significantly beyond Solvency II's agreed 1-in-200 year confidence interval
  - It further undermines the fundamental parts of the Solvency II framework

†Shadow SCR tests solvency using 50yr LLP, UFR shifted down by 1% and non-application of VA, MA and transitional measures

Volatility adjustment

- **Industry strongly supports changes to the VA that result in two clear outcomes:**

  1. **An increase in the overall level of the VA to better reflect the risk premiums that insurers can and do earn above risk free rates**

  2. **Improved effectiveness of the mitigation of artificial volatility of own funds**

- It is recognised that there are potentially different ways to achieve these desired outcomes and industry continues to assess which options are optimal

- However, EIOPA's proposed Approaches 1 and 2 will not achieve these objectives

Volatility adjustment – EIOPA proposals

- **Risk corrections - Industry strongly opposes EIOPA's proposed changes to the calculation of these parameters**
  - Risk corrections should reflect the expected economic cost of downgrades and defaults over the long-term – they should be based on long-term default statistics
  - Making risk corrections a % of the prevailing spread will increase pro-cyclicality of the framework
  - Academia does not support EIOPA's hypothesis that the level of the spread is linked to the default rate
- **Liquidity ratios - Industry does not agree there is a prudential need to introduce liquidity penalties**
  - Concerns about liquidity should be addressed through Pillar 2 and Pillar 3 requirements
  - EIOPA's proposed adjustment for illiquidity of liabilities would create double counting of risks (eg Mass Lapse risk)

DVA in standard formula

- **Industry supports an extension of the Dynamic Volatility Adjustment to the Standard Formula**
  - A DVA within in enable SF users to more appropriately reflect the long-term risk of bond/loan investments which are not exposed to the risk of forced sales
  - Not having a DVA is inconsistent with a key underlying Solvency II principle that stresses should be applied to the total balance sheet ie to both assets and liabilities, as is rightfully the case for all other risks (interest rate risk etc.)
  - The current approach exaggerates the true risk insurers face when investing in corporate bonds and therefore creates unnecessary disincentives and costs
  - No change to the existing scope or calibration of the spread risk module is required

Background

- The excessive size and volatility of the risk margin is a pan-European issue: according to EIOPA figures, the total risk margin was €179bn in Q1 2019

- The cost of capital approach to calculate a risk margin is an attempt to approximate as closely as possible an amount necessary to determine a market or transfer value. It is effectively the best estimate of the cost of the non-hedgeable risks where the best estimate liabilities already capture the costs of the hedgeable risks. Therefore, it is essential that the risk margin does not harbour any prudence in its calculation in line with the best estimate liabilities. Any prudence in the Solvency II framework should be captured via the SCR calibrated at a 99.5^{th} percentile, not in the valuation.

- The cost of capital approach has a number of components that harbour the risk of adding additional prudence in the calculation resulting in too high and too volatile a risk margin. The level of the cost of capital, currently set at 6%, was already highlighted as part of the SII 2020 review. However, it is not the only source of an overly prudent and ultimately excessive risk margin currently held by insurers.

- The industry considers four areas in need of immediate consideration and action with respect to this:
    1. Excessive cost-of-capital rate
    2. Lack of diversification
    3. Excessive volatility with respect to interest rates
    4. No allowance for risk dependence over time

Issue	Industry view
<u>Excessive cost of capital rate</u> • Not a true cost of capital measure: based on a cost of equity, and not a weighted average cost of capital ("WACC"), which is lower • Survivorship bias: use of backward-looking risk premiums results in an upward bias since firms which fail leave the index • Adjustment for pure insurance risks: the reference undertaking is closed to new business and is not assumed to hold any risky assets. The current cost-of-capital rate does not make full allowance for this	Take into account the financing structure of insurance capital, either through direct estimation of the WACC, or the use of an unlevered beta. Equity risk premium should be based on forward-looking risk premiums. The use of a geometric mean in deriving the cost-of-capital rate should also be considered. The estimate of the cost-of-capital rate should be adjusted downwards to also reflect that the reference undertaking is not assumed to hold any risky assets.
<u>Lack of diversification</u> • No allowance for diversification between life and non-life business within the same entity, or between different entities within a group.	The risk margin methodology should be amended to allow for diversification between lines of business within a composite firm and legal entities within a group.
<u>Excessive volatility with respect to interest rates</u> • Longer duration portfolios are the most sensitive to changes in risk free interest rates, resulting in highly material sensitivities.	Effective proposals that can reduce the volatility of the risk margin need to be assessed. It is also clear that an excessively prudent level of the cost of capital amplifies the volatility issue.
<u>No allowance for risk dependence over time</u> • It is extremely important to recognize that certain risks are not repeatable over time. • Certain insurance risks are not independent over time and so projected capital does not equal capital at risk. In such cases, the current approach materially overstates the risk margin if this is not accounted for appropriately. • For example, following a mass lapse stress, exposure reduces by 40%. Under the current approach, capital for a five-year product would equate to a mass lapse rate of 200% - which clearly cannot occur.	It should be clarified that the projection of the SCR in the calculation of the risk margin should allow for risk dependence over time.

Property risk

EIOPA Public Event on the Solvency II 2020 review

Frankfurt, 6 December 2019

German Insurance Association (GDV)

GDV
DIE DEUTSCHEN VERSICHERER

Benefits of real estate vs. the Solvency II property risk factor

- Insurers are an important investors in **the real estate industry.**
- Real estate investments are long-term assets with predictable cash flows.
- The European Commission's goal of completing the **capital markets union** must not unnecessarily be impaired by excessive capital requirements for **long-term investments**.
- **Insurers' recent efforts to diversify their real estate portfolios** and to reduce the home bias should be acknowledged. Any home bias is to be addressed in the ORSA.

Solvency II property risk factor

- Standard formula **property risk factor: 25 %.**
- Solely based on data from the commercial property market from the greater London area which is
  - exceptionally volatile
  - not representative for a typical European insurer's real estate portfolio.
- Based on monthly IPD total return indices for the UK market (1987 to 2008).

We agree with EIOPA that the property risk factor needs to be reviewed.

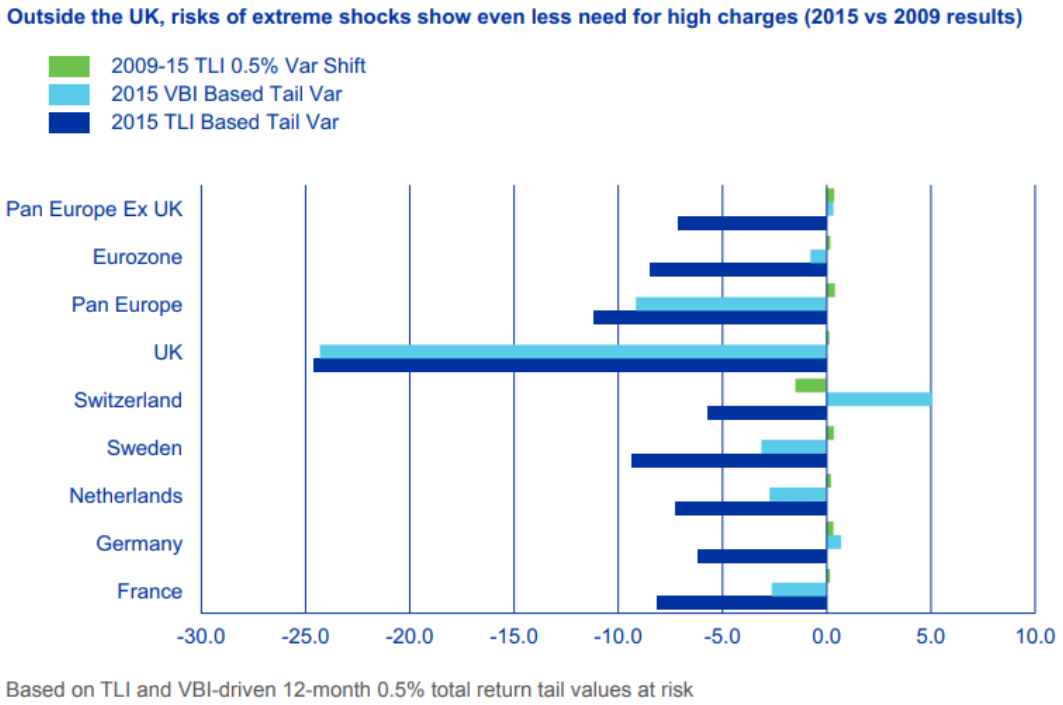
Sources: EIOPA-14-322: „The underlying assumptions in the standard formula for the Solvency Capital Requirement calculation", pp. 21-22; CEIOPS-DOC-66/10: CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR Standard Formula , Article 111b, Calibration of Market Risk Module, pp.-27-32

MSCI real estate Solvency II 2017 update report

- 15-year quarterly data for 17 European markets (2001-2015).
- Valuation based but also using transaction data.

Key finding:

The appropriate shock factors to use for determining real estate solvency capital requirements **need not be pushed in excess of the 15 % mark for all Europe.**



We consider this analysis appropriate.
The industry supports a reduction of the risk factor as suggested by the data.

Discussion of EIOPA‘s analysis

EIOPA’s findings also indicate that the current calibration is not representative for European properties:

*The current calibration was constrained by the availability of real estate annual returns observations where the only source of deep and sufficiently frequent data was available for the **UK** market, **market deemed to be the most volatile one in Europe** and thus potentially not representative for this risk in other countries.*

*For the TLI series the **UK results significantly differ from the ones of the other countries**. The values contributing to the minimum are to be found during the 2008 subprime crisis.*

*For the VBI series, for countries with observations available at multiple frequencies, quite intuitively the lowest minima are always observed at the highest frequency. For these countries only these minima were considered. From the analyses it can be observed that **3 countries (of which UK) have clearly higher risk profiles regarding property risk** than the others in the EEA. However these are countries with the highest number of data points.*

EIOPA is to continue the analysis towards a potential change

- **Current calibration based on „1987-2008“ compared to „1999-2019“.**
- **„Wrong“ data better than „not so perfect“ data?**
- **What are the results of the previous analyses?**
- **What further analysis will EIOPA conduct?**

Wilhelmstraße 43 / 43G
10117 Berlin
Tel.: 030-2020 5000
Fax: 030-2020 6000
E-Mail: berlin@gdv.de

51, rue Montoyer
B-1000 Brüssel
Tel.: 0032-2-2 82 47 30
Fax: 0032-2-2 82 47 39
E-Mail: bruessel@gdv.de

www.gdv.de
www.DieVERSiCHERER.de
facebook.com/DieVERSiCHERER.de
Twitter: @gdv_de
www.youtube.com/user/GDVBerlin

Interest rate risk in standard formula

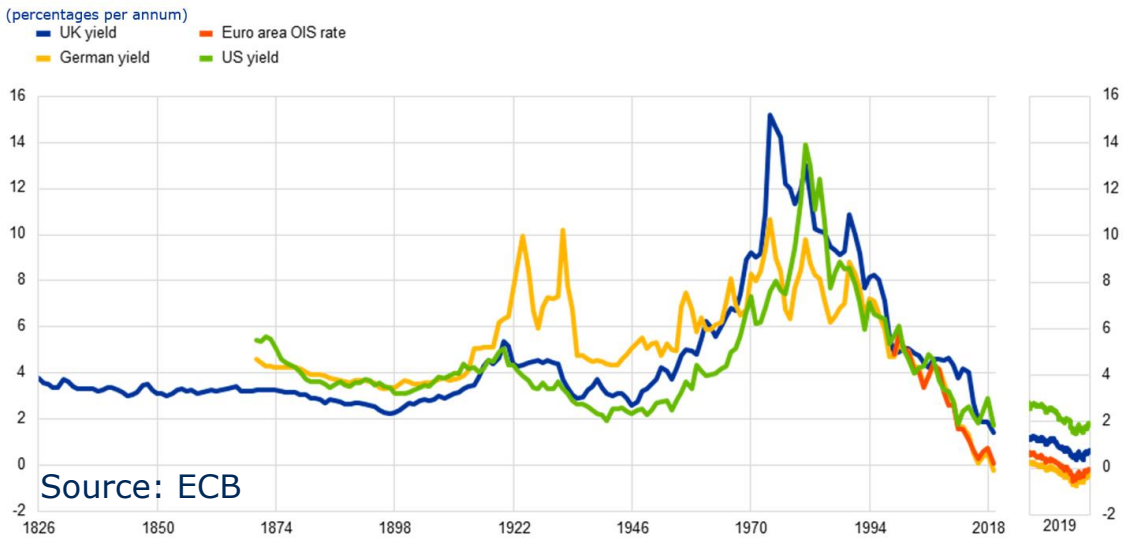
- **Industry does not support EIOPA's proposals**
- **EIOPA's backtesting does not demonstrate that the shocks are in line with a 1-in-200 year scenario**
  - The backtesting indicates the calibrations are particularly inappropriate for the extrapolated part of the curve or for non-Euro currencies
- **Proposed calibration overstates the risk in low/negative interest rate environment**
- **Proposal to calculate the illiquid part of the curve of the stressed risk-free curve using a relative shift is economically incorrect and creates an inconsistency with the calculation of the liabilities.**
  - Should a 1 in 200-year stress materialise, only the liquid part of the curve would be affected. The illiquid part of the curve would then be derived using the extrapolation methodology. Therefore, the proposed stress scenario is inconsistent with the framework methodology

Interest rate risk in standard formula

- **Analysis of historical rates can clearly support the view that we are already in an extreme market environment**
  - Supported by ECB / BoE analysis

Chart 1

UK, US, DE and euro area OIS long-term interest rates



- **It is not clear that the Swiss data is a suitable proxy for calibrating Euro and other currency interest rates**
- **EIOPA has not provided sufficient evidence to justify their additional 1% prudence calibration**

Interest rate risk in standard formula

- **Industry recognises that there are grounds for considering potential changes to the current standard formula interest rate SCR**
  - When rates were higher the SCR calibration appear in retrospect to be low
  - In the past, a 0% floor was considered appropriate while we have experienced negative rates
- **However, great care needs to be taken to ensure that any changes incorporate an appropriate lower bound to avoid excessive impact and unnecessary to insurers long-term business model**
- **In summary, any methodology should…**
  - Stress the liquid part of the curve using appropriate shock factors including an appropriate floor to interest rates
  - Extrapolate the illiquid of the shocked curve using the standard extrapolation techniques (ie Smith Wilson) and parameters eg. UFR, LLP
  - Be appropriate for all currencies in the EEA

reinsurance advisory board

Non-proportional reinsurance: ‘Time to move forward’

Reinsurance Advisory Board
6 December 2019

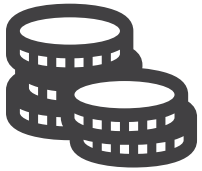
Insurance Europe's Reinsurance Advisory Board

reinsurance advisory board

Solvency II does not recognise companies' use of non-proportional reinsurance in non-life premium and reserve risks

NP RI is predominant RM instrument for NL

Non-proportional reinsurance is the predominant risk mitigation instrument for the non-life sector and a crucial tool for smaller and medium sized companies to manage peak risk. It accounts for more than 50% of total non-life reinsurance premiums in major European markets.



Standard formula not risk sensitive to NP RI

Standard formula users get no capital benefit for using non-proportional reinsurance in the Premium & Reserve risk module. This does not reflect economic reality nor provides good risk management incentives.

Inconsistent treatment with other areas of SII

The CAT guidelines assume that some benefit accrues in the premium and reserve risk module – but in the standard formula, it doesn't. In the Life SCR, NP reinsurance is duly recognised, even though it is less commonly used.

Dissimilar treatment of premium vs reserve risk

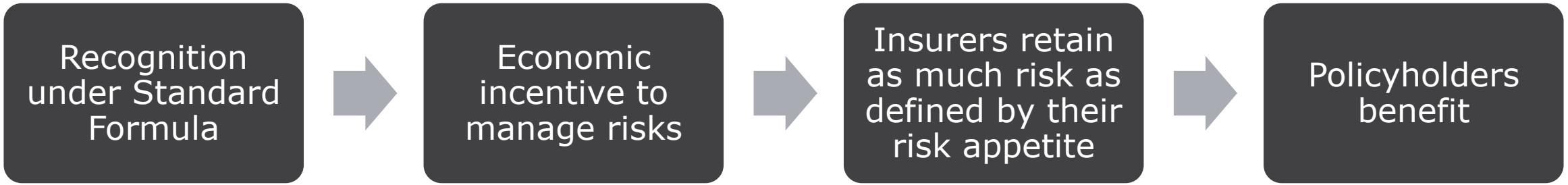
Reserve risk can be significant for general insurers with long-tail business. While NP reinsurance is not recognised in either premium or reserve risk, there is a USP for premium – but not reserves.

Implementing a solution would strengthen SII

In the European Commission's CFA, EIOPA is asked to advise on methods for the recognition of the most common non-proportional reinsurance covers for non-life underwriting risks in the Solvency Capital Requirement standard formula, as well as for adverse development covers and finite reinsurance covers.

This inconsistency needs to be addressed in the Solvency II 2020 review

Finding a solution would give companies the right incentive structure and improve risk management outcomes



The industry's and EIOPA's interests are **aligned** to deliver a solution that would promote **sounder risk management incentives**

Three possible approaches developed by the RAB

SAM approach	Simplified Economic Approach	USP-style
• Inspired by the South African SAM Solvency regime in conscious departure with Solvency II • Allows recognition of aggregate covers and LOB-level covers • The prudential standard clearly specifies that these components allow for risk mitigation that is not allowed for elsewhere	• Impact of reinsurance is calculated as loss-absorption capacity of a 1-in-200 year event = stress factor • Easy and straightforward to calculate • Any overshooting due to double-counting can be easily corrected through application ratio	• Extend approach currently used in Solvency II USP for premium risk to reserve risk • Uses comparison of loss distributions with/without reinsurance for each LOB • This would be incorporated in the standard formula as an option
Attachment: Aggregate Design: Principle-based	**Attachment: per line of business Design: Calculation-based**	**Attachment: per line of business Design: Distribution-based**

reinsurance advisory board

Three possible approaches developed by the RAB: a balance will have to be struck between risk-sensitivity, complexity, and prudency

	Risk sensitivity	Simplicity	Prudency
Status quo	Fixed regardless of risk transfer	Simple, but LoBs treated differently	Reinsurance ignored
1. SAM approach	Highly sensitive due to freedom to model	Need to develop own approach	Gives companies significant freedoms
2. Simplified Economic Approach	Sensitive subject to structural details	Same formula for all LoBs	Can be designed to avoid overshooting
3. USP approach	Highly sensitive	Need to model simple distributions	Prudent enough to already be in SII

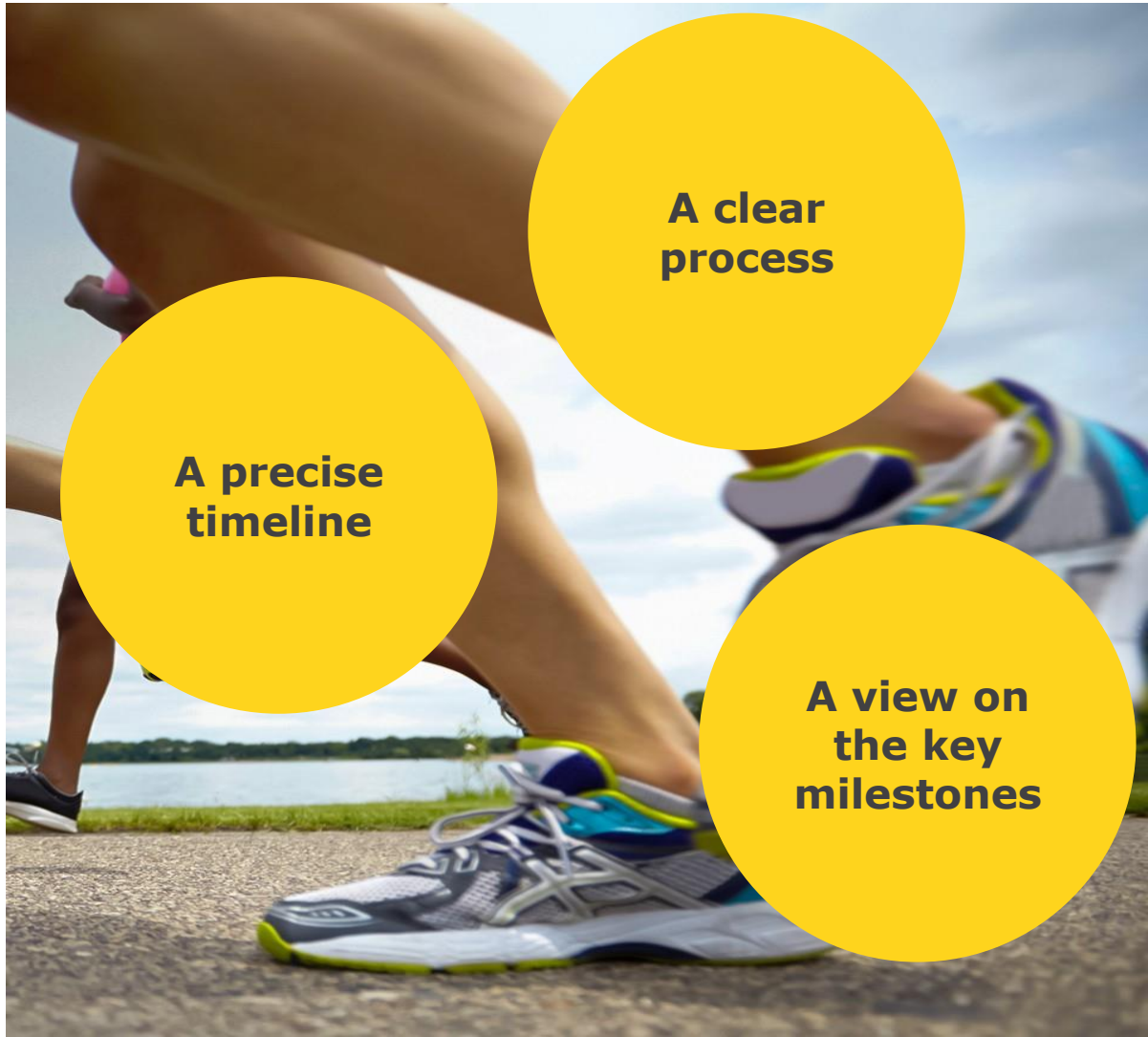
The adoption of any of the approaches described above would be preferable to the status quo.

reinsurance advisory board

Now is the time to move forward

- The inconsistent treatment of Non-proportional Reinsurance in the Standard Formula has been an unresolved issue for years
- Non-life insurers should get benefits from sound risk management practices
- The industry's and EIOPA's interests in finding a solution are aligned and proposals exist
- The 2020 review is an opportunity not to be missed to improve the recognition of Non-proportional Reinsurance in the premium & reserve risk module of the Solvency II Standard Formula

The RAB is ready to assist EIOPA but it needs:



reinsurance advisory board

reinsurance
advisory board

For more information

www.insuranceeurope.eu/reinsurance-advisory-board

EIOPA Public Event on the Solvency II 2020 review – Volatility Adjustment

Frankfurt, 6 December 2019

Volatility Adjustment

- **AMICE shares the main messages presented by Insurance Europe in their presentation today: objectives of the VA, concerns with the Consultation, support of the DVA**
- **In addition AMICE identifies issues that bring the non-life insurers perspective in the debate when assessing if the VA fulfills its objectives of protection of own funds and mitigation of artificial volatility.**

  The issues are threefold and all lead to under protection and under mitigation :

  - Unfavorable duration mismatch due to lack of going concern approach (contract boundaries)
  - Volatility of fixed income assets backing own funds not mitigated
  - Too low application ratio (65%)

- **AMICE also points at the insufficient activation of national triggers and pleads for mortgage loans spreads enhanced modelling**

Volatility Adjustment

- **Yet, AMICE would like to avoid exaggerated complexity in Solvency II and sees the need to adopt a proportionate approach**:
  - **a VA computed on the reference portfolio per currency should be maintained as a default approach** with adjustments where needed to compensate undershooting issues (eg: an increase of the GAR from 65% up to 100% is a very simple adjustment to apply) to counterbalance several shortcomings and reflect better the global balance sheet structure of a specific insurer's case
  - **An entity-based computation of the VA should be an option accessible** where significant basis risk exist

Thank You!

EIOPA Public Event on the Solvency II 2020 review – Equity Risk

Frankfurt, 6 December 2019

Equity Risk

- **The default Equity Risk is very costly in the Solvency II framework with two major downsides :**
  - **Distorted appreciation of an insurer's risk profile** when equities are managed with a long term approach :
    - **in absolute terms but also relatively accross risks (distortion of adequate risk ranking)**
  - **Restrictions in equity investments :**
    - **depriving the economy of key resources for growth, development and innovation,**
    - **the policyholders of attractive returns (life) and competitive prices (non life)**
    - **and the financial markets of the stability and countercyclicality long term investors bring**
- **The default calibration reflects the gross volatility of a diversified equity index over a 1 year time horizon while it should capture its net impact on own funds taking into account all mitigations in place when managing an equity portfolio with a long term stance :**

Equity Risk

- Mitigations exist when no forced sales can be envisaged and the insurer has the choice of the timing of sales and purchases to reflect its risk appetite and extract the long term performance he is looking for and that benefits all parties (policyholders, financial markets and the econnomy). **In such a case management actions modify the net exposure and are key to support the long term strategies** :
  - net of management actions the gross adverse volatility that exist on markets does not materialize in the same level of possible loss
  - under long term asset management strategies target asset allocations are defined in a way that is tested against the holding capacities of the insurer in adverse situations, in other words the capacity of the insurer under consideration to sustain economic and financial cycles and indeed to act in a countercyclical manner
  - as a matter of fact downturns in equity markets constitute purchase opportunities to long term investors and not a right time for selling. On the contrary the development of bubbles is a signal for sale.
  - The management actions are supported by continuous monitoring and scrutinizing by dedicated expert teams of early warning indicators complementing the deep kniowledge they have of markets and of the issuers in which they invest

Equity Risk

- **The case of long term management of equity needs to be better reflected in the framework while other measures such as the MA and VA have provided key solutions for bonds investments artificial volatility.**
- **This is why we have welcomed the important step taken in the 2018 review in that direction with the introduction of article 171a.**
- **Yet, the criteria under 171a fail to properly identify the long term investments equity cases** :
  - We support all governance criteria as key and adequate criteria : strategy and risk appetite, ALM and investment policies together with the management actions associated (notably the holding of sales if the timing is wrong and the practice to act against cycles)
  - The capacity to avoid forced sales should be demonstrated in adequate stressed forward looking scenarios

Equity Risk

- An average holding period criteria is not a relevant criteria as transactions must take place when necessary and any movement (purchase or sale) is modifying the average and bringing it down.
- In a nutshell, the ability to manage an equity portfolio with a long term perspective is best depicted with a criteria asking for a demonstration of **an “ex ante” ability to avoid forced sales in the future** rather than any synthetic number of years of holding period that would unduly constrain management actions in an unsafe and counter effective manner.
- It is also to be noted that selling shares at realised gains should not be a concern in the calibration of the risk (favorable volatility) as this does not translate in a loss. Additionally it is this practice that smooths the long term performance and allows the downstreaming in the annual result of the insurer.

Thank You!

EIOPA Public Event on the Solvency II 2020 review - Proportionality

Frankfurt, 6 December 2019

Disclaimer

- Any views or opinions expressed in the following slides represent current views at this stage of the process
- These views may be further developed in the coming weeks and ahead of the final submission of the comments to EIOPA by 15 January 2020

EIOPA 2020 Solvency II Review - Proportionality

- The principle of proportionality is embedded in the Solvency II Directive, reflecting its core status within the EU Treaties
- Solvency II is a risk-based regime; The application of the proportionality principle is based on the nature, scale and complexity of risks
- The industry reports little or no application of proportionality in practice
- We welcome that the EC's call for advice request to assess whether proportionality in the application of the Solvency II framework could be enhanced
- The lack of a clear and simple definition of nature, scale and complexity of risks has limited the application of the principle of proportionality
- NSAs often perceive themselves as legally restrained from permitting companies to apply the proportionality principle

EIOPA 2020 Solvency II Review - Proportionality

- EIOPA recognized the need for improvement in its supervisory statement, "*Solvency II: Application of the proportionality principle in the supervision of the Solvency Capital Requirement*", in which it highlighted the need for a consistent implementation of the proportionality principle
- The industry supports EIOPA's efforts to improve proportionality but its proposals are far from enough to ensure an effective and efficient application of proportionality
- Changes are needed to ensure that the principle of proportionality works in practice and will be available as a potential tool for all companies

Insurance Europe – AMICE Proposals

- The Directive must make clear that **NSAs have a duty** to always consider where they should allow companies to deviate from any specific requirements due to proportionality considerations, either by using approximations, simplified approaches or by not applying a requirement where appropriate
- **A "toolbox" providing a non-exhaustive list of simplifications**, alternative calculation methods and/or exemptions from certain reporting templates that can be automatically applied by companies when some predefined and risk-based criteria are met
- EIOPA should publish an **annual report on proportionality** including proposals on how to improve its effectiveness and consistency

Insurance Europe – AMICE Proportionality Toolbox

- Introducing a **clear risk-based specific criteria** for the automatic application of the measures of the tool box
- EIOPA should develop these **clear risk-based criteria aiming at assisting NSAs** in their assessment of the nature, scale and complexity of risks and increase transparency in the application process of the principle
- A **predefined risk-based criteria** should allow NSAs to identify **low risk companies**, based on their overall scale, nature and complexity
- Companies would be automatically entitled to apply a list of simplifications and waivers, without any additional burden of proof and **without possibility for NSAs to object (there is not pre-application process)**

Insurance Europe – AMICE Proposals

- Individual measures of the tool-box can be **applied by all insurers** -> Proportionality could also mean choosing to not apply an individual requirement, on a case-by case basis -> Proportionality applies also for more complex insurers on non-material risks and lines of business
- EIOPA's annual report on proportionality, and any follow-up, should be **overseen by the new proportionality committee** which is required to be set up by the ESAs review
- Applying proportionality **should not result in gold plating**, and proportionality should not be mis-used to increase the burden for some insurers
- A proportionate supervision is key to ensure that Solvency II is effectively a risk-based framework

Thank You!