



EIOPA stakeholder event: COVID-19 implications for the Solvency II review

Industry presentation
23 October 2020

Agenda

- Introduction
- COVID-19
 - Overview
 - Need to improve VA
 - Need to lower Risk Margin
 - Risk free rate methodology & calibration should not change
 - Need to change Interest rate SCR for negative rates with appropriate floor and methodology
 - No evidence for new macro-prudential tools or own funds buffer
 - Need to assess holistic impact at different times
- Other topics for meeting agenda
 - Own Funds Buffer
 - Equity risk

Objectives

- **Strong support for current SII objectives:**
 - Policyholder protection
 - Financial stability
- **But objectives should be added to support:**
 - Insurers' investment in long-term, sustainable investments
 - Competitiveness of European insurers in Europe & internationally
- **Key objectives for 2020 review:**
 - Address measurement flaws to remove obstacles to:
 - Investments in long-term and sustainable assets
 - Offer of long-term savings and pension products, including guarantees
 - Reduce operational burden (make proportionality work, streamline reporting)
 - Avoid new requirements or unnecessary changes – only where real evidence of need & justified by cost/benefit assessment

Insurers' role in supporting the economy: obstacles and solutions



-  **Valuation of liabilities, especially long-term liabilities, are exaggerated**
-  **Market volatility has an excessive impact, especially on long-term business**
-  **SCR for investment assets is too high relative to real risk**




Improve VA

-  To better reflect the returns insurers earn and better mitigate volatility

Lower risk margin

-  To correctly calibrate CoC, time-dependent lambda factor and diversification

Improve SCR for investments

-  To recognise that real risk is to long-term underperformance not short-term price volatility)

COVID-19: an unprecedented event but ...

- Insurers demonstrated **strong operational resilience**
 - Continue to service clients and to pay claims at a normal pace
- Insurers generally maintained their **robust solvency position**
- Industry remained strong and proved resilient and **did not need or get capital support**
- Confirmed the **need for focused improvements to SII framework** and importance of effective long-term measures

EIOPA: balanced statements and actions

- **Statement** (*March 17*):
 - highlighting industry's strength
 - clarifying that MCR is the actual minimum
 - noting tools available to NSAs in SII
 - need for insurers to follow prudent dividend policies
- **Statement** (*March 20*) supporting flexibility on reporting deadlines (though not necessarily used)
- Revision of 2020 review timetable
- **Call to action** (*April 1*), highlighting that imposing retroactive coverage of claims could create material solvency risks and threaten policyholder protection and market stability, thereby aggravating financial/economic aspects of crisis

However, strong concerns on blanket dividend ban

- SII already provides a **strong basis and governance framework for dividend distributions** so blanket bans are unnecessary and unwarranted.
Dividend payments are already governed by multiple safeguards and constraints.
- Blanket dividend suspension regardless of individual undertakings' situation, is **harmful** to the insurance sector, **undermines the credibility of SII** and has a **range of adverse consequences** including:
 - disruption of income flows for investors (eg pension funds) who rely on dividends
 - disruption to capital and liquidity management within insurance groups, compromising their ability to effectively manage the solvency of their entities
 - increases the cost of capital and undermines the underlying investment rationale of the sector as a consistent source of regular dividends
- There is no need for any additional EIOPA/NSA powers on dividends

Industry actions to help customers ...

- Industry actively contributed to and signed up to EC initiative on best practices (14 July) for insurers, banks and non-bank lenders, aimed at providing relief to consumers and businesses in wake of COVID-19
- Best practices reflect broad range of initiatives and (goodwill) actions insurers have already been taking — both individually and collectively — since beginning of pandemic to reduce impact on clients
- It is vital to take into account local situations and needs, so goodwill initiatives vary between countries and companies
- In future, need to ensure terms, conditions and exclusions are crystal clear

COVID-19 has not: indicated weaknesses or deficiencies in capital or management

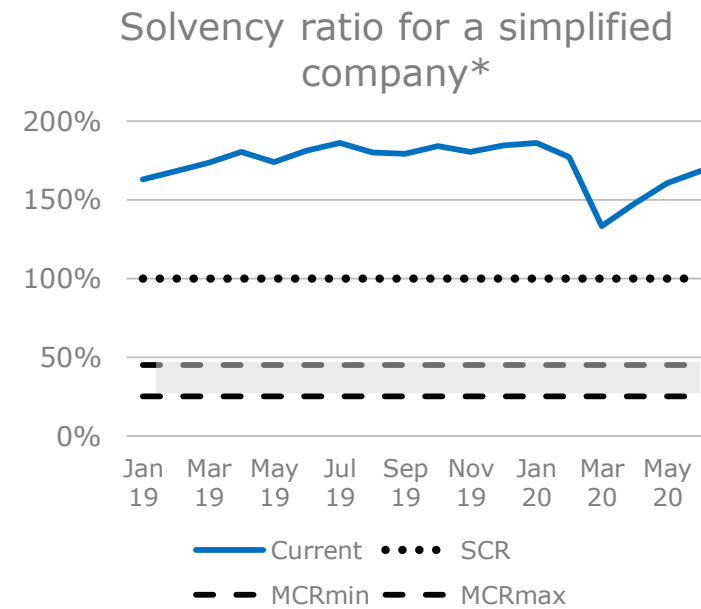
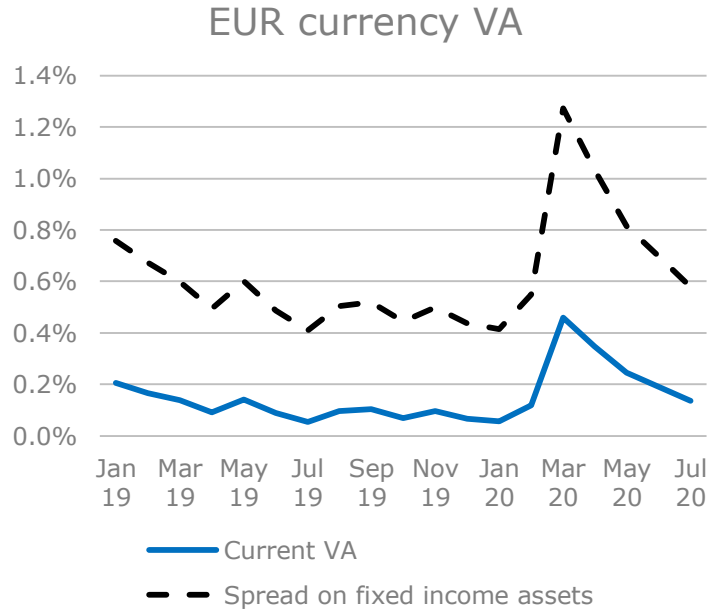
- Ratios remained high and well above regulatory minimum MCR and required target SCR **showing that chosen buffers were more than high enough**
 - **MCR above 593% (Q1 2020)**
 - **SCR ratio 225% (Q1 2020)**
- **Liquidity (remains) well managed** and not an issue of concern
- Strength of industry should not be excuse to increase capital requirements or add further undue prudence

COVID-19 has:

- Provided further **evidence** that
 - VA needs improvement to ensure its ability to effectively mitigate the level of market bond spread volatility
 - Risk Margin is too high and volatile
 - Risk free rate curve methodology should not be changed
 - Interest rate shock needs updating to incorporate negative interest rates but with an appropriate methodology and floor
- Indicated that **EIOPA proposals would amplify and not address current flaws** and would therefore not support objectives of SII Review
- Created an **even more urgent need to remove any barriers** to insurers contributing to Europe's recovery, growth and sustainable transformation
 - By addressing the flaws noted above, fixing the long-term equity criteria and including a DVA in the standard formula applied to the existing spreads, while maintaining the internal model DVA as it is

COVID-19 has: highlighted SII's volatility issue

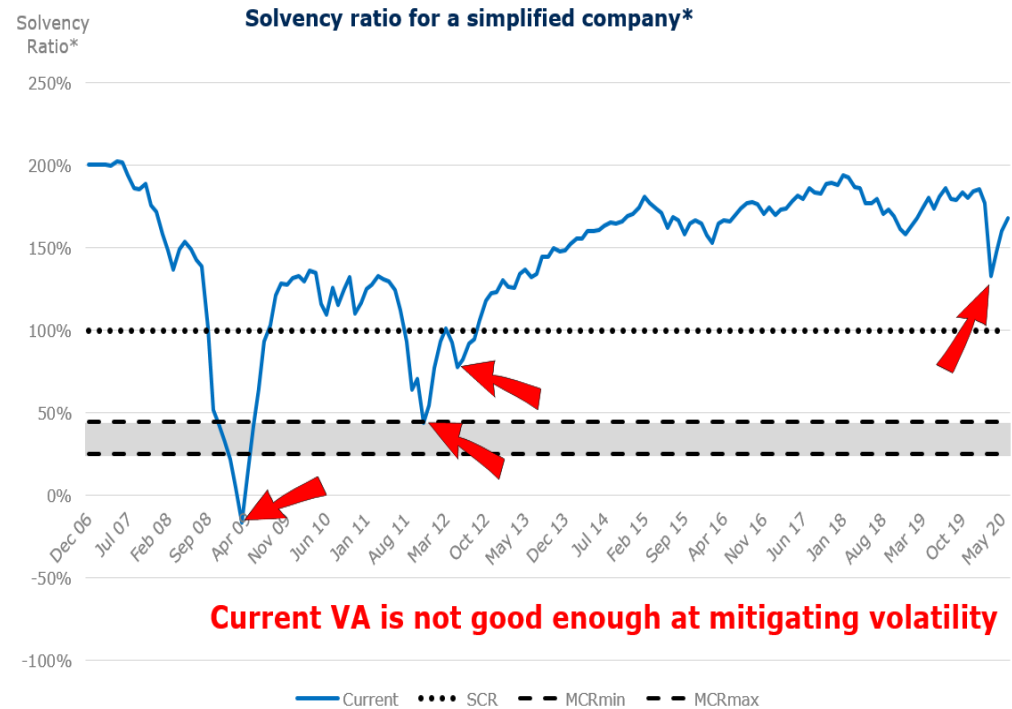
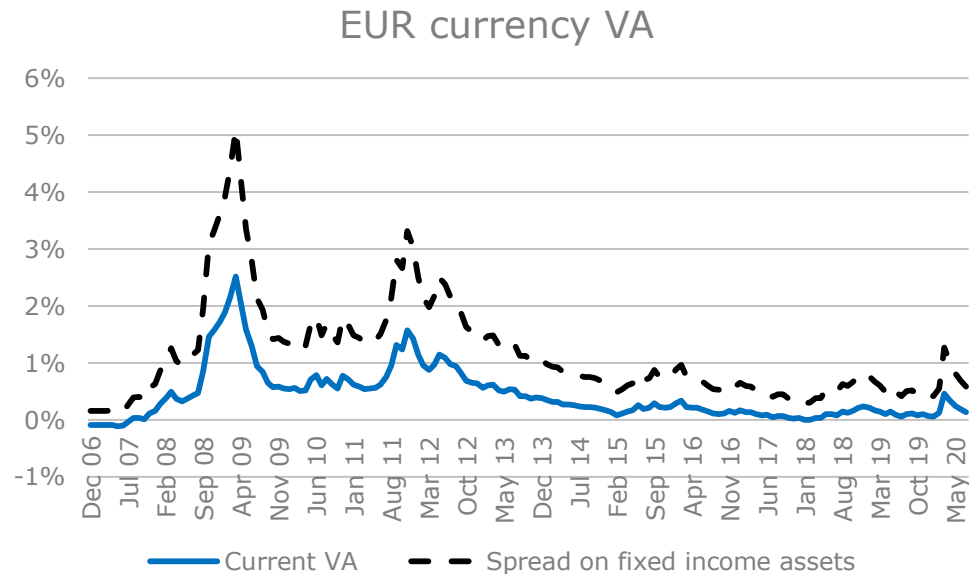
- Spread (& other volatilities) peaked in March triggered by COVID-19
- Current VA does not work well enough, so such volatility can create large artificial movements in SII ratios because in reality insurers are not significantly impacted



* Simplified example of an insurance company with 10-year liabilities, fully matched with 10-year maturity fixed-income assets invested in exactly the reference portfolio. As our focus is on balance sheet volatility, for simplicity the SCR is assumed to stay constant over time.

COVID-19 has: highlighted SII's volatility issue

- However, volatility has been much, much worse in the past (e.g. 2009)
- VA needs improving to avoid this translating to solvency volatility and creating a significant barriers to long-term business

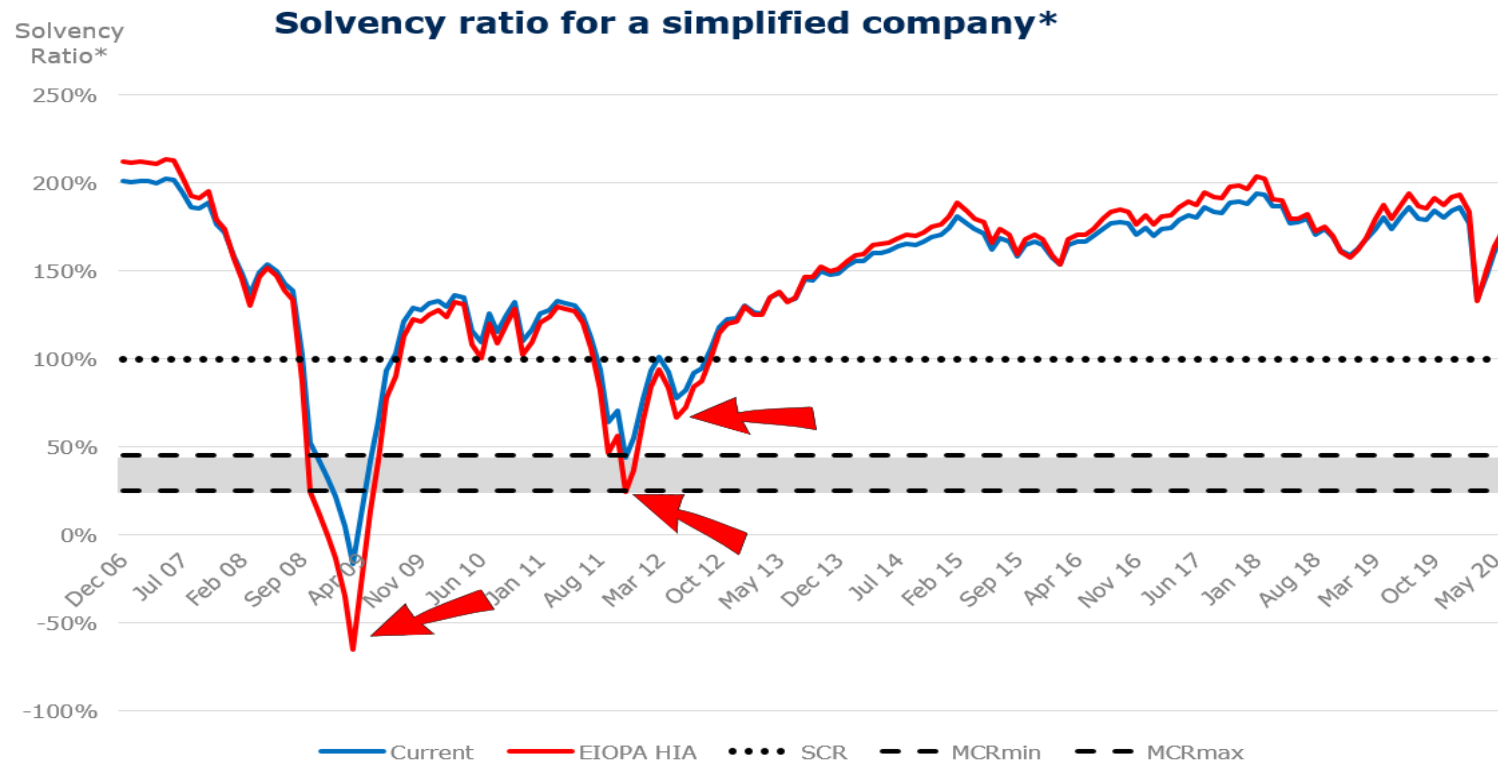


Current VA is not good enough at mitigating volatility

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COVID-19 has: highlighted SII's volatility issue

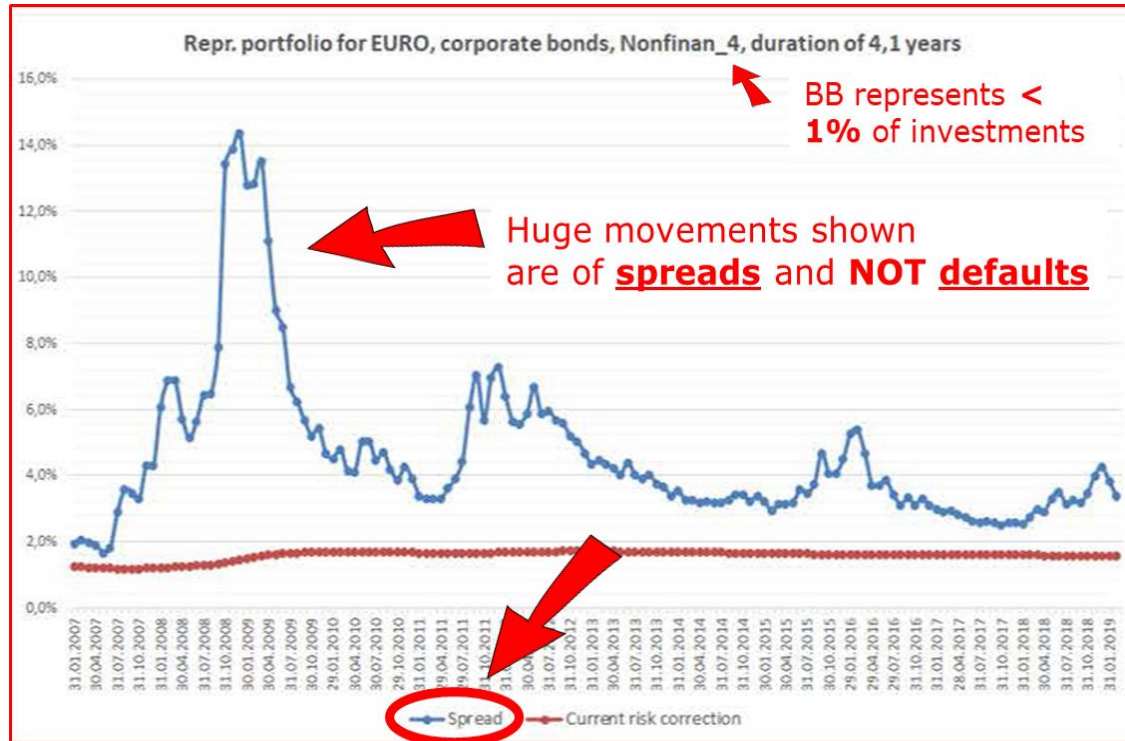
- EIOPAs set of VA changes would make VA worse not better
- This is because of changes to risk correction and liquidity factor
 - These will make the VA more volatile, more procyclical, less effective and more complicated than necessary



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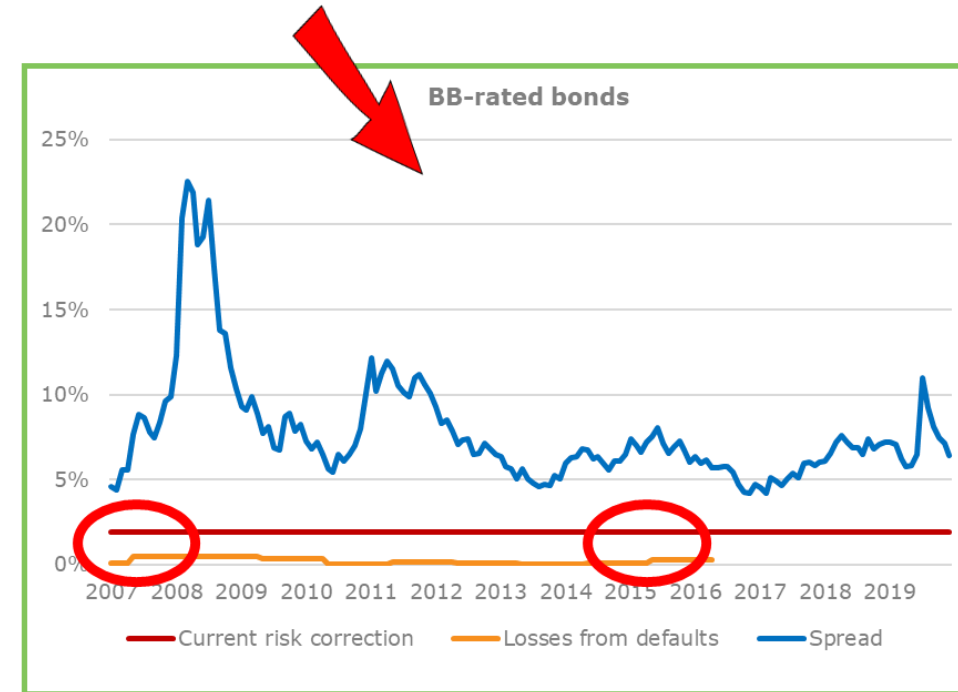
Risk correction: proposals and justification flawed

Justification used for change is flawed



EIOPA-BoS-19/465 "Consultation paper on the opinion on the 2020 review of Solvency II" p93

Looking at the actual losses from defaults



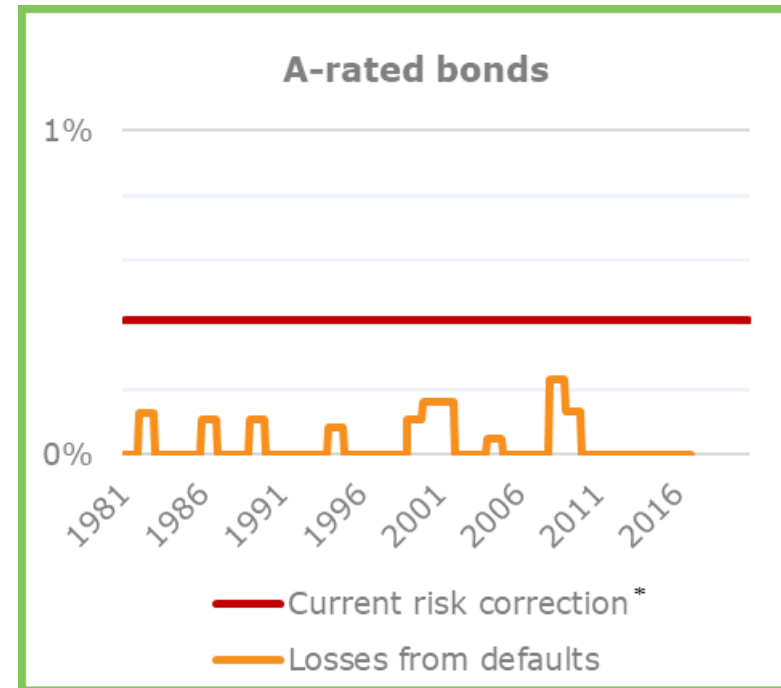
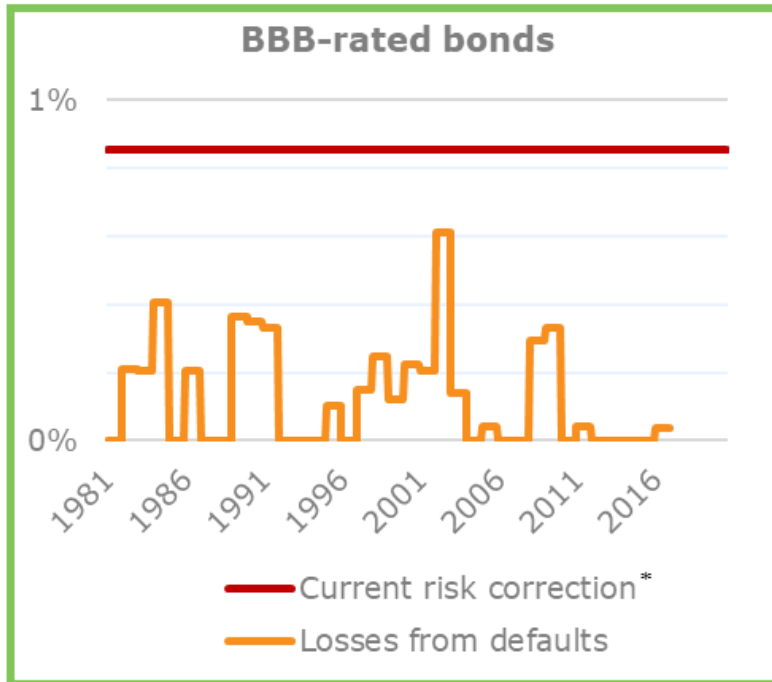
... BUT below current risk correction, which is conservative enough



Risk correction change not needed: already overly conservative

Risk correction change not needed: already overly conservative

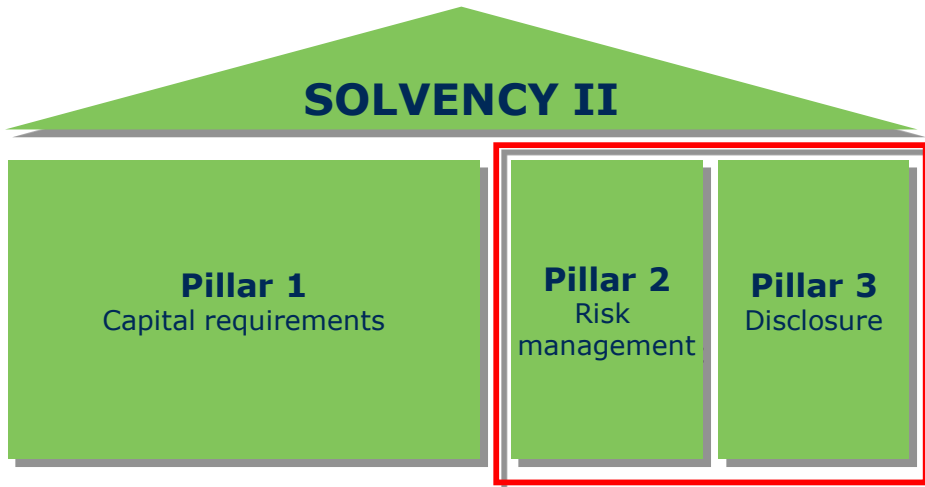
- Confirmed by loss data going back to 1981
- Even more true for bonds held more significantly by insurers, eg BBB or A



* Risk correction assumes equal split between financial and non-financial bonds

Liquidity should be dealt with under Pillars 2 and 3

Unnecessary for Pillar 1 and



... too complex to include as a simplistic factor

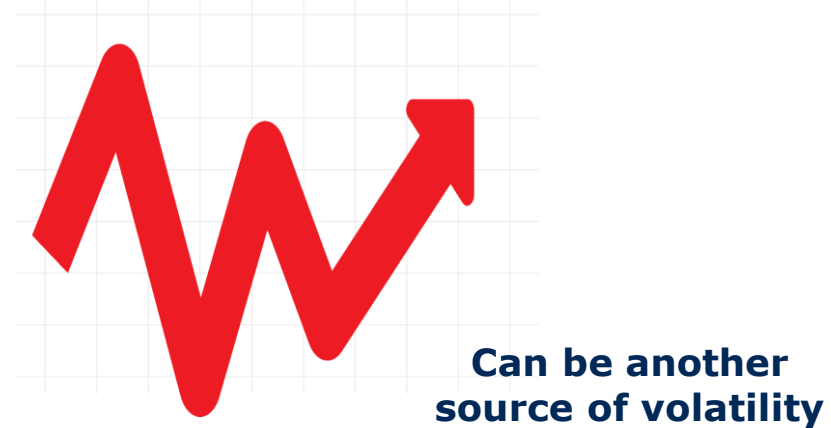
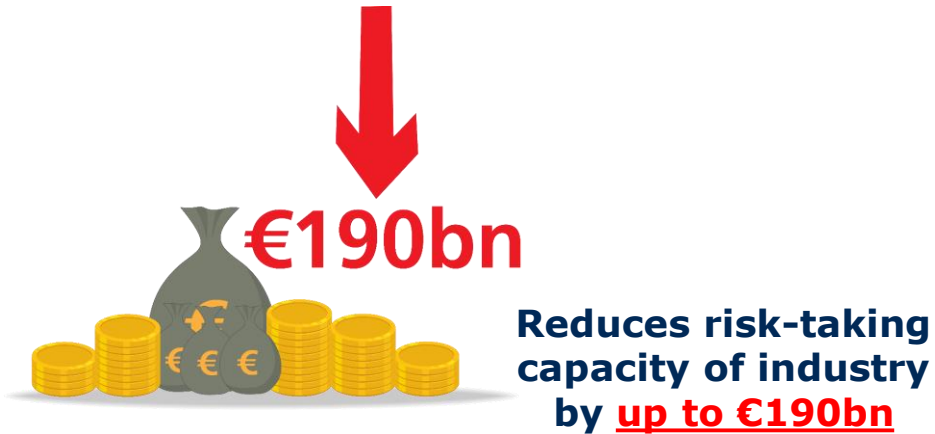
Correct, meaningful liquidity assessment

- **Causes of liquidity in liabilities, eg:**
 - Lapse shock, etc
- +
- **Mitigants, eg:**
 - Supervisory powers to intervene to prevent lapse shocks
 - Customer penalties (imposed by insurer or tax authorities)
- +
- **Sources of liquidity, eg:**
 - New premium flow
 - Maturing investments and income from investments (dividends, rental income and interest payments)
 - Liquid assets including cash, shares, bonds
 - Reinsurance
 - Committed credit lines
 - Intra-group liquidity

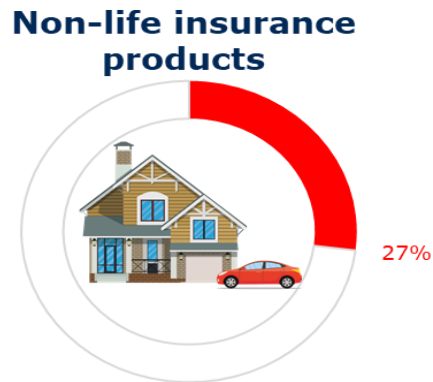
... and would lead to some double-counting



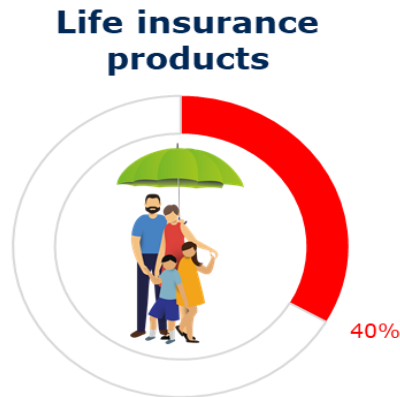
Risk margin is unnecessarily high



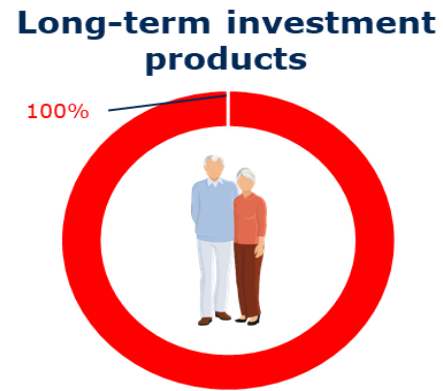
And is extremely punitive for long-term products



Risk margin is **27%** of SCR on average



Risk margin is **40%** of SCR on average



Risk margin can be in excess of **100%** of SCR

Strong justifications for material reduction of risk margin



Cost of capital



Diversification



Risk changes over time



EIOPA's lambda proposal does not address the issue sufficiently

Risk free rates: No need for change and concerns with EIOPA's proposals

Current methodology



- **Meets all criteria** defined in Solvency II
- Uses **appropriate** market data
- **Reflects** standard asset-liability management practices
- **Fully incorporates** current very low/negative rates

EIOPA proposals



- **Increases the costs** of long-term liabilities
- **Increases** industry dependence on **derivatives**
- **Increases volatility** for many insurers



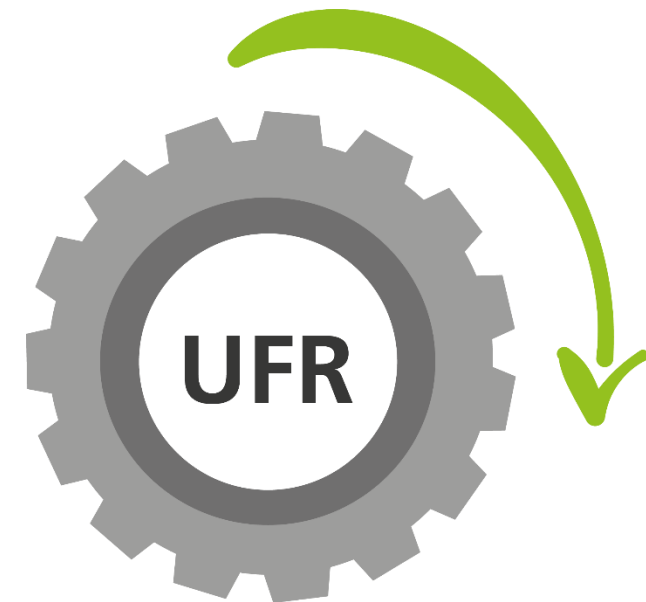
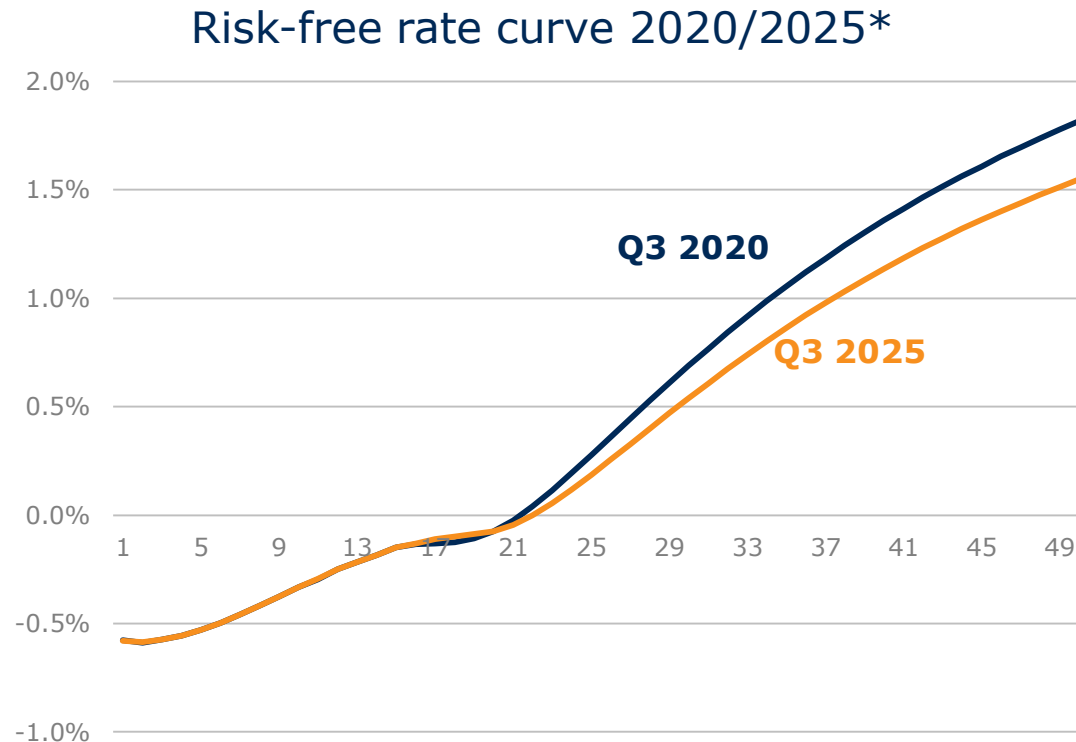
EIOPA proposals would increase value of liabilities and can increase volatility and would make it even harder for insurers to maintain long-term business

Risk-free rates: Current methodology should not be changed

- COVID-19 highlighted that IR movements are another source of volatility. Changes that amplify this should be avoided
- SII criteria for determining LLP are clear and appropriate: all point to lower or **no change to Euro LLP**
 - DLT criterion - Spreads of Euro-denominated bonds are currently comparable to their 2014 levels (see EU Bid-Ask Spread Index) indicating stable liquidity.
 - Matching criterion - EIOPA's analysis ignores massive amount of bonds purchased by ECB. Taking this into account, cash flows from year 16 onwards can no longer be matched. **No LLP increase warranted, a reduction might even be considered.**
 - Residual volume criterion - EIOPA's analysis did not take into account that financial/Euro crisis has led to lower average credit quality and that ECB purchases removed high-quality bonds from market. For investment-grade bonds net of ECB purchases, bonds with maturities ≥ 20 years (current LLP) are clearly below 6%. So, **residual volume criterion points to lower LLP.**
- Bond criterion needs to be maintained as well
 - Switching to a pure swap criterion will likely force insurers to cover their interest exposure with swaps but current net volume of swap market is far from sufficient to cover European insurance obligations.
 - It could also lead to higher systemic risk: increases interdependency between banks and insurers. Possibly, only hedge funds would be willing to act as ultimate counterparty.
 - In certain MS there are constraints preventing insurers from using swaps, eg Germany

Current methodology already incorporates low interest rates

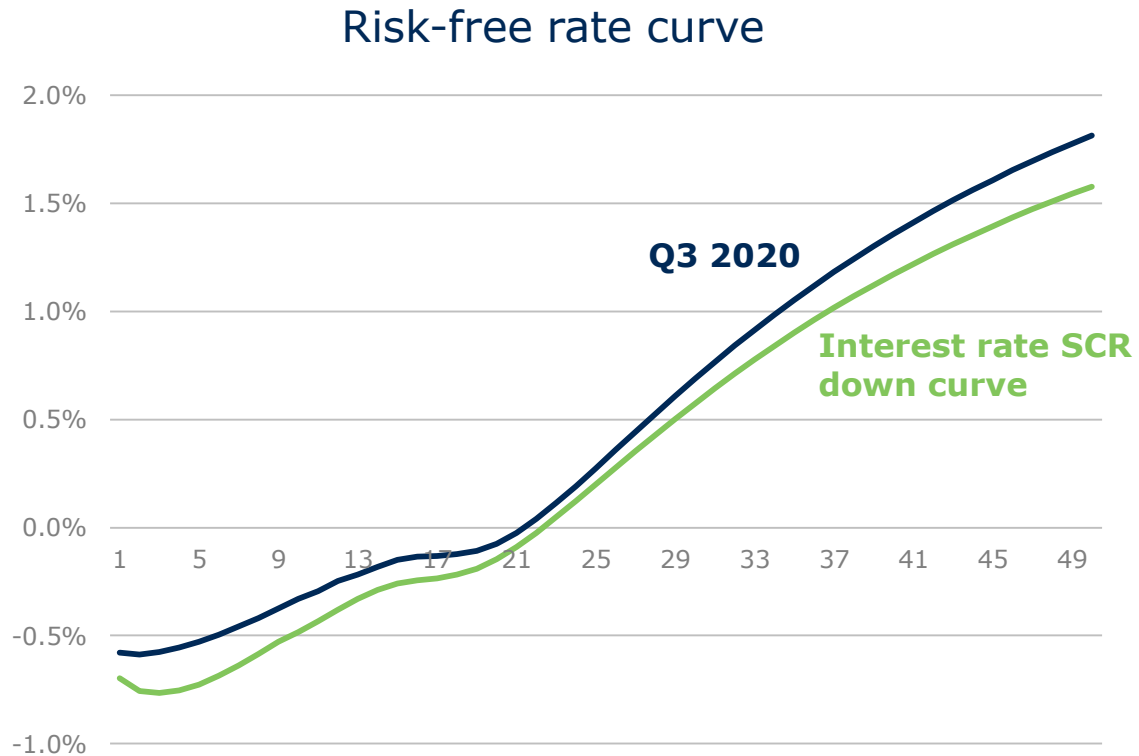
Changes to ultimate forward rate (UFR) over the coming years will already lower the risk-free rates further



* Note: 2025 Risk-free rate curve assumes 2020 swap rates and 3.30% UFR

Capital requirements provide further protection

Interest rate SCR* ensures there is capital to cover the eventuality that the risk-free rates fall further



* Note: Interest rate down curve projected using Insurance Europe proposal

Interest rate SCR:

Change justified but only with appropriate floor and methodology

- COVID-19 confirmed risk of negative risk-free rates and need to change interest rate SCR methodology
- The **change to the “shifted approach” methodology is supported** as this provides more appropriate interest rate SCR when rates are very low and allows for negative rates
- However, EIOPA’s proposed methodology needs to be **changed to avoid unnecessarily extreme scenarios and so it works for all currencies**:
 - **The curves should be shocked until the LLP, then extrapolated**
 - **The floor should be calibrated based on a more appropriate worst-case outcome** – ie at a less negative level
- Alternative proposals to address these concerns have been made, including one from IRSG ([here](#)).

Macro-prudential tools

- **No evidence of need for new tools before COVID-19 or after**
 - **SII was designed for and already allows early intervention by supervisors:** through SCR/MCR & ladder of supervisory intervention, requirement to report imminent breach, ORSA projection requirements, etc.
 - Plus, SII includes certain recovery requirements :
 - Recovery plan in case of non-compliance with SCR
 - Finance scheme in case of non-compliance with MCR
 - Supervisory powers in deteriorating financial conditions
 - Insurers continue to represent extremely limited systemic risk
 - A pandemic is a non-insurable event so is a non-systemic event for insurers
- No justification for: even earlier intervention before SCR is breached, new concentration limits, counter-cyclical buffers or dividend controls
- **Only EC measures in CfA should be considered and applied in a proportionate way, if at all**
 - Empower supervisors to temporarily prohibit early surrenders in specific circumstances.
 - Recognise importance of cross-border cooperation and coordination between supervisory and/or resolution authorities within EEA and in third countries, as well as mutual recognition of resolution actions.
 - Pre-emptive recovery planning only where it would provide tangible benefit, as determined by NSA.
 - Resolution only as last resort, once all recovery options exhausted and only in rare situation of insurer non-viability.
 - Liquidity has remained under control but recognise scope for improved documentation on liquidity risk management by companies.

No need for an own funds buffer

- The **inclusion of an additional discretionary buffer to be applied when credit spreads are excessively compressed is unnecessary**
- EIOPA itself notes a number of problems with the approach:
 - It would create additional complexity
 - It could distort the level-playing field and make solvency information less comparable, as NSAs could have divergent approaches to application.
 - It could lead to double counting as spread risk is already taken into account in SCR
 - A buffer is not really needed, as SII already has tools to mitigate procyclicality, ie VA and MA
- It would add additional capital to a framework which is already unnecessarily burdensome
- **The industry strongly opposes the proposal to introduce an own funds buffer for compressed spread**

Need to assess impact carefully

- EIOPA originally planned to assess holistic impact only at one point (Q4 2019) and in aggregate
- Industry has long highlighted need to assess/test how SII works under range of situations and especially during times of extreme conditions and market volatility
- COVID-19 situation has helped show, with new HIA for Q2 2020, that a single point of time assessment is not enough to determine if changes and calibrations are appropriate
- Changes should be made on basis of proven need and evidence-based risk and economic approach – not on an arbitrary target for a (balanced) outcome on an arbitrary date
- In addition to assessing the impact at European level, the following should also be considered:
 - Member states
 - Types of business, especially long-term business
 - Different points in time, especially in financial crisis
 - Impact on EC's objectives for CMU and sustainable investments



EIOPA stakeholder event on the COVID-19 implications for the review of Solvency II

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