

Insurance Europe key messages on EIOPA consultation on illiquid liabilities

Draft for discussion and review at Ecofin Committee meeting– 7 December 2018

The current treatment of long-term insurance business and long-term investment by insurers under Solvency II is overly conservative. This is primarily because Solvency II generally assumes that insurers are exposed to the risk of loss due to forced asset sales on their entire investment portfolio. This assumption is flawed and has a number of negative consequences which result in an overestimation of the value of liabilities and excessive capital requirements which are not reflective of the risks which insurers are exposed to.

Insurance Europe therefore supports the investigation of insurer's ability to avoid forced asset sales and consideration of the illiquidity of insurance liabilities would be part of this work. Work on forced selling should form a key basis of regulatory changes which aim to improve the Solvency II framework to improve the treatment of long-term liabilities and long-term investments.

As noted by EIOPA, the assessment of the illiquidity of liabilities should identify the features of the insurance liabilities which may impact the ability of insurers to hold their assets without being forced to sell. Where forced selling can be avoided a number of important economic effects need to be reflected in Solvency II:

- The insurer can earn an illiquidity premium which should be reflected in the discount rate used to valuation the liabilities.
- The nature of asset risk changes from a short-term exposure to price changes to a long-term under-performance.

EIOPA's proposed approach

EIOPA has proposed to develop a number of "illiquidity indicators" without providing sufficient information on how these indicators will be used. Further information on EIOPA's intentions with regard to these indicators is needed to enable stakeholders to provide more comprehensive input on how they should be designed.

EIOPA has proposed to assess the illiquidity of the assets and liabilities separately. Insurance Europe considers this approach to be fundamentally flawed:

- It does not reflect how insurers manage their liquidity (and other investment) risks in practice. A holistic assessment of illiquidity which encompasses all asset and liability cashflows (including other sources of liquidity such as profits from other businesses and new premiums reinsurance) is preferable and will provide a more representative view of the true liquidity risks. A holistic approach is the only way to capture an insurer's asset-liability management (ALM) and liquidity management.
- It is limited to an assessment of existing policies. In reality, an insurer is likely to have a significant source of additional liquidity from own funds or from future premiums arising from existing contracts, renewals or new sales. Own funds are kept in a going concern perspective, can be very predictable and held over long periods of time. Future premiums not only provide a regular and

predictable income stream but also provide stability to the balance sheet i.e. as older policies mature, they are renewed or replaced which provides the insurer with a predictable liability profile to support investment in long-term assets.

Insurance Europe also regards the methodologies proposed by EIOPA to be highly theoretical and likely to provide only limited insight into real-world liquidity considerations and risks.

- An assessment of the “terms and conditions of the contract (e.g. cancellation rights)” gives qualitative information on the potential illiquidity of each contract. It provides information of what is theoretically possible but no information on what is probable. As shown in EIOPA’s analysis, contract design is largely unrelated to average surrender/cancellation rate. However, EIOPA did not assess the link between terms and conditions of the contract and the volatility of lapse rates.
- An assessment of the duration of insurance liabilities in stressed circumstances does not appear to provide sufficiently useful information from which to appropriately assess the insurer’s liquidity profile.
- The sensitivity of liability cash flows when exposed to stress conditions allows a quantitative analysis. However, the proposed approach is not practicable beyond simple examples and does not consider the sources of insurer’s sources of liquidity.
- EIOPA’s paper puts significant focus is put on analysis and measurement of the holding period of individual investments. However, it is not at all clear how the holding period of individual assets impacts the risk of force selling. It does not appear to be of any prudential relevance. An insurer selling at a gain is not a concern – it is being a forced-seller during a temporary market price drop that is of concern.
- Long-term investment cannot be defined by the holding period of individual securities. Any assessment of long-term investment should focus at a portfolio level. There are many valid reasons, consistent with good risk management practices, why an insurer will transact within its long-term portfolio including reduction of concentration, portfolio optimisation and rebalancing.

EIOPA has indicated plans for an extensive data collection exercise early in 2019 on the basis of this consultation. However, the data collection can be expensive and resource intensive for insurers and it is premature to do such an exercise before there is greater clarity over the overall framework, methodologies and how they will be used in practice to achieve better alignment between Solvency II and long-term risks. Once this is clear a data exercise may indeed be of value and can be appropriately designed.

Insurance Europe proposal

Insurance Europe considers that the “illiquidity indicators” should be the exposure to losses arising from forced asset sales. The most appropriate way to measure this risk would most likely be through an appropriately designed liquidity stress test. For simplicity, Insurance Europe proposes that exposure to forced sales, required to meet the liquidity needs, should be assessed on the basis of a deterministic scenario including liquidity events the insurer is exposed to (i.e. for the majority of insurers this is likely to be a lapse event).

Once the insurer is able to identify its exposure to loss due to forced asset sales, then it will be able to identify the portion of its assets which are “long-term” assets. These assets provide the insurer with an



illiquidity premium which should be incorporated into the discount rate used to value the liabilities. They are also exposed to long-term asset risks which should be reflected in the capital requirements for these assets; for bonds, this is default risk and for equities it is long-term underperformance (taking into account dividends as well as capital gains/losses).

DRAFT