

To: Economics and Finance Committee

From: ECOFIN Team

Meeting: 7 December 2018

Reference: ECO-18-107

Subject: Solvency II – 2020 review

Objective

For discussion and agreement

Input requested

This note provides an update on recent work on the 2020 review, following the ECOFIN mandate of June. The secretariat will give a presentation on the key points, including extracts from the recent Joint Industry 2020 Review Workshop.

We seek member discussion and decision on three areas:

- 1) High level priorities for the 2020 Review
- 2) First steps towards developing an industry view on the improvements to the LTG package in the 2020 Review i.e. the emerging conclusions from the joint industry workshops
- 3) High level messages on EIOPA's consultation on illiquidity of liabilities

Summary

Please find below the areas for discussion and on which we seek ECOFIN agreement.

1. High level priorities for the 2020 Review

The secretariat recommends developing clarity on the priorities the industry seeks for 2020 and proposes the following (based on previous feedback) for discussion:

- **LTG Measures:** Significant improvements to remove barriers to long-term products and investments (but not for green incentives) – covering discount rates, risk margin, and SCR calibrations for market related risks
- **Proportionality:** Making it work in practice (some of this can be done ahead of the 2020 review too)
- **Reporting:** Streamlining and reducing burden of SII reporting
- **Other technical issues:** A limited number of important technical issues where SII does not capture the economics of insurance correctly. Non-proportional re-insurance could be an example.

2. First steps towards consensus on LTG improvements needed

Emerging conclusions from the workshop on which the secretariat is seeking views from Ecofin members are:

General explanation

- A focus on whether or not assets are exposed to force-selling is helpful in explaining the problems and justifying changes, both
 - setting of discount rate because it impacts the ability to earn an illiquidity premium

- calibration of SCR for market risks because it impacts whether the insurer is exposed to short-term price risk or longer-term underperformance of asset returns
- Analysis of projected cashflows can provide a more intuitive illustration of the long-term nature of the business and highlight issues which market valuations can fail to capture

Adjustments to the Risk-Free-Rate curve are made (ie MA/VA):

- The industry supports maintaining the existing two-bucket approach (MA/VA)
- Significant improvements are needed for the VA and two potential options should be further investigated and assessed against the set of criteria:
 1. a significant recalibration of the existing methodology (eg increase application ratio, change representative portfolio, country adjustment)
 2. introduction of VA v2.0 which is based on own assets allocations but standardised spreads (sometimes referred to as a "WAMP" approach)
- No significant changes to the MA, but certain potential refinements to be investigated

On SCR Asset calibrations

- There is a difference between the nature and size of risk between exposure to short-term price risk and long-term under-performance - this needs to be reflected in SII which is a risk based framework
- This can be achieved by a short-term price risk calibration (similar to the current one) and a long-term under-performance one (needs to be developed).
- The scope of assets that require recalibration and the approaches to recalibration will be further investigated but two specific potential solutions have already been identified
 1. Long-term equities (no material at risk of force-sales) would have an SCR calibration of 22% - this is under discussion as part of the 2018 Review changes to DAs
 2. Use of a Dynamic VA to achieve appropriate calibrations for bonds has been proposed by a number of members and will be included in the work going forward

3. High level messages on EIOPA's consultation on illiquidity of liabilities

These are currently under development and discussion at working level and will be shared ahead of the ECOFIN Committee meeting.

Background

Update on Insurance Europe work on the 2020 review

In line with the June Ecofin mandate, two joint workshops with the CFO Forum have now been held.

- The first of these was well attended with 57 participants from associations and companies and focused on the theme of *Valuation: Discounting liabilities*. During the workshop, Olav Jones provided an overview of the industry's concerns and industry representatives, from both companies and associations, presented both their concerns about Solvency II and their ideas for possible solutions. The presentations can be found [here](#) and [here](#).
- The second workshop, held earlier this month, was also well attended with 58 participants from associations and companies and included presentations from a number of participants. The themes of this workshop were a continuation of 'Valuation: Discounting liabilities' and 'Market risk SCRs'. The presentations can be found [here](#) and [here](#).

A third joint workshop with the CFO Forum will be held in March (date tbc).

EIOPA Request for input on Illiquid liabilities

On 29 October, EIOPA released a *Request for Feedback on Methodological Considerations regarding Illiquid Liabilities* (see [here](#)). The consultation runs until 7 December and a follow up workshop with industry is being held in Frankfurt on 13 December.

EIOPA is investigating the illiquidity features of liabilities. This consultation is an important precursor to the 2020 Review. It proposes three methodologies for assessing the illiquidity of insurance liabilities:



1. Terms and conditions of the contract (e.g. cancellation rights)
2. Duration of insurance liabilities in stressed conditions and
3. Sensitivity of liability cash flows when exposed to stress scenarios

It also requests feedback on EIOPA's analysis of the investments of insurers. This includes analysis of holding periods which have been derived from QRT data and proposed methodologies for assessing the long-term risk of holding corporate bonds and equities.

Key messages are under development but at this stage, the preliminary views emerging include:

- The risk of forced asset sales is central to the ability of the insurer to hold their investments over the long term. Any assessment of liquidity needs therefore needs to consider whether it would actually trigger the forced sale of assets – not focus only on detailed liability features.
- Any assessment of the illiquidity needs to consider cashflows from assets and liabilities holistically.
- EIOPA approach on liability illiquidity is overly-theoretical.
- Long-term investment cannot be defined by the holding period of individual securities and needs to be assessed at portfolio level and related to strategic asset allocations.
- The analysis of actual holding period is not relevant – the risk of forced-selling is relevant.

Next steps

Insurance Europe will organise a third workshop on the 2020 review in March 2019.

Regarding EIOPA's consultation on illiquid liabilities, the deadline for the consultation is 7 December and a workshop with the industry is organised on 13 December.