insurance europe

Memo for information

To: Solvency II Working Group
From: Prudential Team

Date: 16 January 2018
Reference: ECO-SLV-19-011

Subject: Summary of EIOPA 2018 LTG Report

Comment

On 18 December, EIOPA published its 2018 Report on long-term guarantee measures and measures on equity risk (LTG Report) (see FLASH-18-150).

This is the third LTG report and is based on undertaking's financial position at year-end 2017. Consistent with the 2017 report, it contains an assessment of the overall impact of the LTG package on:

- the financial position of undertakings;
- policyholder protection;
- investment;
- consumers and products;
- competition and level playing field; and
- financial stability.

It also contains a more in-depth analysis of each individual measure and a thematic section on risk management.

The quantitative analysis shows a similar picture to the 2017 report (which is to be expected given the broadly similar economic environment). However, EIOPA has included several new analyses in the 2018 report which may provide an insight into their current work on the 2020 review. These include the impact of the dynamic volatility adjustment, an analysis of the volatility of the RFR curves and further testing of MA portfolios.

A summary of the secretariat's analysis of the report is included below and the main quantitative results can be found in the annex. Should members have any comments, please contact prudential@insuranceeurope.eu.

Background

EIOPA are mandated to provide an annual report on the impact of the application of the LTG measures and measures on equity risk to the EP, Council and Commission. The analysis contained in these reports will form the basis of an EIOPA Opinion on the assessment of the application of LTG measures and measures on equity risk which it expects to finalise in 2020.

The 2018 LTG Report is based upon data collected from the QRTs as at 31 December 2017 and an additional data request (see here) which sourced data on the parameters used in the extrapolation of the RFR, bond defaults in MA portfolios and information on European insurance products.

The secretariat's main observations on the content of the report include:

Impact on the financial position of undertakings

- At least one measure is applied by 737 undertakings covering 74% of the total EEA technical provisions.

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- Removing all LTG measures would reduce the average SCR ratio of undertakings using any of the measures by 59% points (from 231% to 172%).
- Extending the last liquid point for the Euro RFR curve to 30 years would reduce the average SCR ratio of undertakings most affected by 24% points (from 238% to 215%).

<u>Impact on policyholder protection</u>

- **NSAs raised no concrete observations** on positive or negative effects of the LTG measures or equity risk measures on policyholder protection.
- EIOPA has provided a rough analysis which shows that there are many undertakings who currently apply the VA but do not have sufficient exposure to credit spreads to earn the VA from fixed income assets. This analysis could be used to suggest that **VA provides undue capital relief** (eg where an undertaking is applying the VA but is not earning the VA on its assets).
- An analysis of the **fundamental spreads used in MA portfolios** shows that the calibration of these spreads is more than sufficient to absorb the losses incurred due to downgrade and default over the year.

<u>Impact on investment</u>

- **No EEA-wide trends** in investment behaviour were noted by NSAs (although several jurisdictional level trends were reported).
- One NSA noted that the current RFR extrapolation methodology **incentivises undertakings to reduce their level of cashflow matching**.
- EIOPA has provided an analysis of the level of asset returns achieved by undertakings during 2017. This shows that **the average total return was 2.2%** (excluding equity and property).

<u>Impact on consumers and products</u>

- An analysis of the information on European insurance products provided by undertakings shows that 84% of products in the sample contain a guarantee.
- **Only 17% of VA users who responded to EIOPA's survey stated that the VA impacted pricing and design of products**. This increase to 94% for MA users.

<u>Extrapolation of risk-free rates</u>

- EIOPA's analysis of **RFR curve volatility** shows that changing the last liquid point (LLP) and the convergence speed will increase the volatility of the RFR curves.
- However, analysis of the **volatility of individual insurer's Own Funds** shows that for some insurers with extensive cashflow matching changing the LLP to 30 years would reduce volatility of Own Funds. This argumentation would clearly support any proposal to extend the LLP.

<u>Matching Adjustment</u>

- **A comparison of the MA and non-MA portfolios** shows that there is limited difference between the credit quality of these portfolios at a national level. This analysis supports the claim that the use of an own-assets approach does not generally result in insurers lowering the credit quality of their portfolios to benefit from higher yields.
- An analysis of the level of **cashflow matching within MA portfolios** has also been provided by EIOPA. As cashflow matching is a prerequisite of the use of an MA, it is perhaps unsurprising that the analysis shows that MA portfolios are well matched in aggregate.

<u>Volatility Adjustment</u>

- The **dynamic volatility adjustment (DVA)** is permitted by 9 NSAs and is used by 53 solo undertakings.
- An assessment of the impact of removing the VA on the aggregate SCR illustrates the large impact **the use of a DVA has on capital requirements**. At EEA level, removing the VA would increase the average SCR by:
    - 1% for standard formula users
    - 2% for internal model users without DVA
    - 25% for internal model users <u>with DVA</u>.

Annex – Quantitative summary of impact of LTG measures and measures on equity risk

	Number of firms applying measure/ in sample	EEA market share of undertakings using measure/ in sample	EEA SCR with measure	EEA SCR without measure	EEA SCR with measure	EEA SCR without measure	Impact on EEA capital req'ment	Impact on eligible own funds to cover SCR
			Undertakings applying measure		All undertakings			
LTG measures								
Matching adjustment	34	15%	160%	79%	239%	223%	34	-36
Volatility adjustment	696	66%	239%	222%	239%	230%	24	-5
Transition on RFRs	7	0%	206%	156%	239%	239%	0	-1
Transition on TPs	162	24%	218%	142%	239%	224%	6	-84
All measures	**737**	**100%**	**231%**	**172%**	**239%**	**201%**	**64**	**-126**
Scenario analysis of RFR extrapolation parameters (†)								
1. Euro LLP moved to 30yrs	363	58%**	238%	215%	-	-	13	-29
2. Convergence point moved to 90 yrs*	363	58%**	238%	233%	-	-	3	-7
3 UFR decreased by 1%	363	58%**	238%	226%	-	-	6	-17

† Extrapolation analysis and results are based upon a sample of undertakings determined using a materiality threshold (see page 34 of report for more details)
*Convergence moved to 50 years for Swedish krona
** Life and Composite

Duration-based equity risk sub-module

- Used by one undertaking with negligible impact at EEA level.

Symmetric adjustment to equity risk

- Used by all undertakings who use the standard formula to calculate the equity risk charge.
- EIOPA has estimated that the impact of removing the symmetric adjustment to equity risk to be -1% on the EEA SCR.