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Extrapolation of risk-free interest rates

Workshop on 2020 review
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Background

- Extrapolation is one of the LTG measures, therefore subject to the review.
- CfA of the European Commission asks EIOPA to provide evidence on the DLT assessment, with a focus on the last liquid points.
- Risk-free interest rates for the euro derived from swap rates. LLP is currently 20 years.
- The choice of this LLP is not based on the liquidity of swap markets, but the result of several provisions of Solvency II that restrict the LLP:
 - o Article 77a: Requires that bond markets are deep, liquid and transparent up to the LLP.
 - o Recital 30 of the Omnibus II Directive states: Should be possible to match liability cash-flows up to the LLP with bond cash-flows (matching criterion).
 - o Recital 30 further states: Under market conditions similar to those at the date of entry into force of the Omnibus II Directive the LLP for the euro should be 20 years.

Available public references:

- Findings in the previous **LTG report's**: Different experience was reported by NSAs addressing the conflict between market consistency and stability of the interest rate term structure.
- **ESRB** published a report on the macro prudential consequences of regulatory risk-free yield curves in August 2017 including specific suggestions for the euro curve.

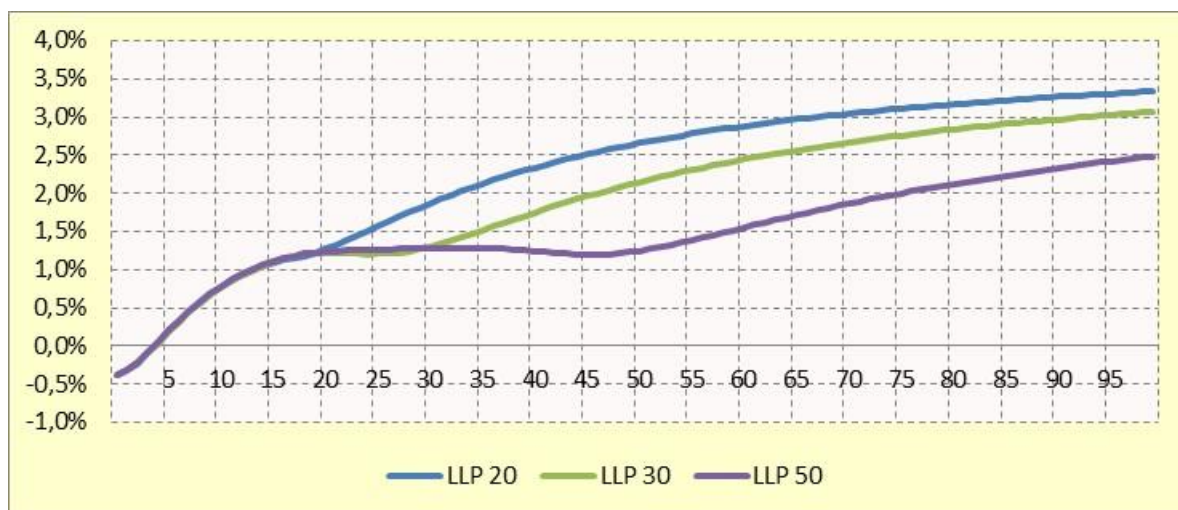
Issues identified with the setting of LLP for the euro:

Issue I: Underestimation of technical provisions

Issue II: Risk management incentives

Issue III: Stability of the solvency position and limiting procyclical behaviour

Issue I: Underestimation of technical provisions



Difference of UFR compared to rate at LLP determines difference in observed level of swap rates compared to extrapolated rates.

Where differences persist: Risk that persisting losses deteriorate financial position and put policyholders at risk.

Issue II: Risk management incentives

- Key question in risk management: Hedging risks reflected in solvency balance sheet or those that are reflected in financial markets?
- Hedging risks in financial markets may increase volatility in OF.
- Does a low LLP incentivise undertakings to hedge based on SII interest rates?
- LTG reports illustrated: Influence of SII requirements on investment decisions varies across countries pending local prerequisites

Where SII requirements are relevant for investment decisions: Deviation of interest rate term structure from observable market prices may give wrong incentives for adequate risk management.

Issue III: Stability of the solvency position and limiting procyclical behaviour

- Volatility of interest rates influences volatility of TP and OF, influenced by level of interest rate hedging applied.
- Where undertakings have long-term liabilities and are not closely matched, early start of extrapolation increases stability of TP and OF.
- Does a higher LLP lead to pro-cyclical investment behaviour (where interest rates fall, buying long-term swaps could put pressure on swap rates)?

Options identified

- Option 1:** The LLP for the euro stays at 20 years and additional safeguards are introduced in pillar 2 and 3 to address issue II.
- Option 2:** The LLP for the euro is increased to 30 years.
- Option 3:** The LLP for the euro is increased to 50 years.