Note drafted by the Eurofi Secretariat

REVIEW OF THE SOLVENCY II LONG-TERM PACKAGE

1. The Long-Term Guarantees package

In May 2014, in addition to transitional measures intended to facilitate the implementation of the new insurance sector solvency framework, the European Union introduced the so-called Long-Term Guarantees package. Finally, regarding long-term Guarantees underwritten by insurance undertakings, the Solvency II framework encompasses in addition to a yield-curve extrapolation, the following elements:

- **An Equity symmetric adjustment (SA) mechanism** with respect to changes in the level of equity prices, included in the market risk module of the standard formula for the SCR.

  The calculation of the symmetric adjustment is based on the behaviour of an equity index built by the EIOPA exclusively for that purpose.

  The mechanism smoothens short term evolutions of equity markets so as that they do not impact the solvency position of undertakings in order to avoid in particular encouraging speculation behaviours (equities bought to benefit to short term market price raises) and fire sales triggered by solvency constraints suddenly raising due to short term general downward evolutions of equity prices.

- **A volatility adjustment (VA)**, which consists of linking the discount rate for undertakings' liabilities to an adjusted risk-free curve, which incorporates a correction corresponding to the evolution of the spreads between risk free rates and those observed for a reference portfolio.

  The mechanism smoothens the volatility of the valuation of the liabilities resulting from short term spread volatility.

- **A matching adjustment (MA)**, which links the discount rate for a liability to the credit-risk-adjusted yield earned on the assets backing those liabilities (restrictive conditions on the underlying business are imposed). This takes the form of a constant addition to the risk-free curve for portfolios for which both the obligation and the related asset portfolio can be identified, organised and managed separately from other activities of an undertaking.

  Naturally the probability of default of the assets (based on long- term statistics) and the loss resulting possibly from downgrading the assets are deducted from the matching adjustment.

  The matching adjustment is added to the whole yield curve after extrapolation. The impact of the matching adjustment on the financial statement is publicly disclosed.

- **Extension of recovery period:** certain lasting adverse situations require increased flexibility on the side of the supervisors to favour greater stability. In this context EU regulation allows supervisory authorities to extend the recovery period by a maximum of seven years from the normal 6-month recovery period, if an exceptional situation has been declared by the EIOPA after consultation with the European Systemic Risk Board (ESRB).

  A combination of matching adjustment and volatility adjustment or transitional measures is not permitted.

  These regulatory measures aim at facilitating the detention of long-tenure assets and avoiding focussing the asset-management strategy of insurers on shorter-term to the expense of the insurers' traditional role as a stabiliser of market volatility. This results mainly, from preventing pro-cyclical investment behaviour ("forced sales") by mitigating the effect of an extreme widening of bond spreads in stressed market conditions and more generally from market short-term volatility.

2. Solvency II standard formula: inspiring measures already proposed in the 2018 review

Anyway, in the draft regulation published on 9 November 2018 and open for consultation until December, in the context of the current review of the standard formula of the Solvency II prudential framework, the European Commission has already introduced new provisions notably to assign a reduced capital charge of 22% to certain ring-fenced equity investments subject to long-term investment requirements: the average holding period of the equity investments must exceed 12 years and must be higher than the average duration of the liabilities held in the ring-fenced portfolio. The intention to hold the equity investments for the long term must be documented and the insurer must be able to demonstrate that the investment can overcome stress scenarios.

Beyond the proposed adjustments intended to simplify the standard formula and observing the principle of proportionality, the aim here is to reduce the constraints that are hindering the financing of the economy notably in the form of listed and non-listed equities, for assets held for long term liabilities.

An assessment of a preliminary version[1] of the proposed adjustment regarding the potential impacts resulting from the introduction of such a specific long-term category of equity holdings, estimated that:

[1] Report on a new category of equities (LTEIP) under Solvency 2 Standard Formula Nov 2018 - Institut des actuaires/PwC.

- 50% of equities held by European companies could be eligible for such a classification;
- Consequently, the coverage ratio would be improved by up to ten points if the shock is reduced to 22%;
- European insurers applying the Standard Formula (or a partial internal model that does not cover equity risk) could reinforce their allocation in equities up to 20%;
- This would correspond to additional purchases of equities in the range of 50 and 100 EUR bn.

3. LTG is widely used by insurance undertakings

Most measures of the LTG are widely used and their impact on the LTG on the SCR and on Eligible own Funds are material.

The calculation of the EIOPA is that at EEA level the average impact of removing the SA on the SCR is -1% in 2018. The impact of removing the Volatility Adjustment would have be +3% and the Matching Adjustment +5% (increases of capital requirements).

4. Scope of the review

The Long-Term Guarantees elements of Solvency II Directive must be reviewed by the Commission in 2020. However, the fundamental principles of the Solvency II Directive (including the confidence level underlying the calibration of capital requirements and the market-consistent valuation) are not subject to review. Yet, the 2020 review is expected by the Commission to allow a holistic and thorough assessment of the framework.

Market participants expect that on the occasion of the review, some excessive regulatory constraints to insurance companies wanting to invest in certain asset classes will be attenuated, though maintaining the necessary prudence.

In addition to recent evolutions some advocate also amending the capital charges regarding the investment in unrated bonds and unlisted equities. Strategic participations by insurance companies are also raising much interest in Europe.

It is also considered as essential that insurance undertakings, as long-term investors, integrate environmental, social and corporate governance factors in their investments and product design and disclose such risks to the public. But it is also essential from a prudential point of view that sustainable and green investment be covered by the appropriate requirements reflecting their specific risks.

Regarding the LTG, one issue to address is the fact that these measures have had an impact on solvency positions that has varied greatly according to the country in which they have been applied.

5. Beyond the current scope of the review

Existing LTG measures mainly seek to reduce the volatility of capital requirements stemming from market volatility.

However, the package does not address the possible over estimation of asset risks resulting from this short-term volatility factored in the calibration of the related capital charges and which have not been taken into account although when the assets are held on the long term, they do not need to be sold rapidly on any conditions.

Neither does the package substitute a longer term for assessing the risk of the assets, which should be consistent with the maturity of liabilities. It only relies on possible market (short term) shocks on the market value of these assets, which badly account for the effective risk, which an undertaking is facing in such a case, which mainly stems from the uncertainty regarding the cashflows of the asset.

An area for reflection is also to consider the progress made and the main issues observed in the single market regarding the supervision of EU insurance undertakings e.g. consistency of national supervisory practices, supervision of LPS insurance activities, etc. ■