Green position on long-term guarantee measures in response to EIOPA's impact assessment report

Background
Solvency II is a comprehensive reform and harmonisation of European insurance regulation that introduces in particular market-consistent balance sheets and risk-oriented capital requirements. It was agreed by the European Parliament and the Council in 2009.
Since then the financial crisis has negatively affected European insurers in at least two ways : (1) the insurers' corporate bond, equity and, particularly over the last few years, government bond investments have lost a significant amount of value (2) the interest rates have fallen drastically and may stay at a low level for a longer time making it difficult for insurers to earn guaranteed interest rates.
Since 2011 the European Parliament and the Council have been discussing measures, referred to as "long-term guarantee measures", that provide relief to the troubled industry. The controversial trilogue negotiations were interrupted in September 2012 to allow an impact assessment of the measures by EIOPA. EIOPA's report about the impact assessment is expected by 14 June.
The measures tested include a classical "matching adjustmen"t that is beneficial in particular for the UK and Spanish annuity market, the "counter-cyclical premium" that especially helps insurers in Italy, Spain and Portugal that are affected by losses on sovereign debt and the risk free yield curve extrapolation methodology, that supports in particular insurance markets with long-term insurance contracts and highly-rated sovereign debt such as Germany.
A draft of EIOPA's report indicates that the combined measures would have provided a relief to the industry in 2011 in the range of **200 bn€ .** This amount is substantially greater than the total amount of new premiums for EU life insurers (163 billion euro) for that year[1].
It should be noted that like for the banking stress test the figures of the assessment were provided by the insurance industry.

Green position

- It is desirable and necessary to take measures in order to avoid that **temporary financial market distortions, especially** with respect to government bond spreads trigger procyclical supervisory actions, such as a requirement to raise capital just when markets are at their most disrupted.
- However, such measures should not grant permanent capital relief that could disguise **unrecoverable losses** or the risk of under-provisioning in the face of continued **low interest rates and economic growth** . Such situations require swift and consequent supervisory action.
- In order to allow an **informed decision** of the European Parliament about the long-term guarantee measures, EIOPA should report in sufficient detail on the financial situation of the national insurance markets without the application of such measures tested as well as the amount of capital relief that the measures provide.

[1] source: http://www.insuranceeurope.eu/uploads/Modules/Publications/life-2011_final.xls

- EIOPA recommends replacing the **counter-cyclical premium** by a new measure called the "volatility balancer". The counter-cyclical premium is a crisis tool that only exists in times of stressed markets. The volatility balancer is a permanent measure. It would be contradictory to the overarching policy holder protection and financial stability objectives of Solvency II to grant permanent capital relief to insurers. The measure should either be temporary or, as suggested by the ESRB,[1] symmetric so that insurers establish additional provisions in periods of market exuberance that they can release to absorb asset losses in downturns.
- With respect to the **extrapolation** of discount rates, it is regrettable that the most important element of the extrapolation, the **ultimate forward rate** that significantly determines the level of the extrapolated rates, was not tested in the assessment. The setting of the ultimate forward rate, the expected long-term level of future interest rates, requires **democratic legitimation** as it represents a collective bet on long-term economics**.** It should not be left to the discretion of an authority, but should rather be specified in the regulatory technical standards of Solvency II.
- EIOPA recommends against the introduction an **extended matching adjustment** proposed by Council. This decision is welcome. The extended matching adjustment is prudentially unsound as it incentivises insurers to hold illiquid assets and the very wide range of policies covered exposes insurers and their policyholders to the risk of runs (policyholders demanding to cash out their policies and insurers being forced to sell illiquid assets rapidly, at a discount).
- EIOPA recommends several modifications of the **matching adjustment** of much more restricted application as supported by the European Parliament. The recommendation on the inclusion of mortality risk[2] goes beyond both the latest European Parliament and Council position and raises concerns about the soundness of the measure. EIOPA's recommendation to allow BBB rated assets (which is just one notch above "junk" status") under the matching adjustment goes beyond the ECON report on Omnibus II that excluded such investments to avoid insurers taking on too much credit risk. Since it is a permanent measure, the matching adjustment should be designed to be not only subject to very prudent restrictions but also truly symmetrical.
- EIOPA recommends introducing **transitionals** for the calculation of technical provisions that phase in the rules of Solvency II over several years. Such transitional measures are preferable to measures that distort the realistic assessment of insurance liabilities permanently.
- EIOPA's recommendation to ensure full **transparency** about the impact of the long-term guarantee measures on each insurer's solvency position is also

[1] See letter of the ESRB of 29 June 2012.

[2] The recommendation to allow insurance products with mortality risk under the matching adjustment contradicts the fundamental assumption underlying the matching adjustment that insurers can keep their bonds to maturity. This is not possible with respect to mortality risk where early payments may need to be made. Applying the matching adjustment to insurance products with mortality leads to insufficient provisions and endangers the protection of policyholders.

very welcome and an essential part of an acceptable compromise on the measures.

- EIOPA should monitor the application of the long-term guarantee measures in the national markets and **report annually to the Parliament** about the capital relief granted and the coordinated supervisory actions taken to address the underlying problems, in particular the risk of unrecoverable losses and the risk of continued low interest rates.
- EIOPA’s recommendation to avoid **Member State options** in relation to the introduction of the long-term guarantee measures will contribute to a consistent application of Solvency II and promote the Union's internal insurance market.
- The whole debate on the long-term guarantee measures has been principally driven by demands from the insurance industry. EIOPA’s report therefore also reflects some of these demands. The debate about how best to frame insurance regulatory policy in the general interest is dominated by the industry while other stakeholders such as consumer protection groups or academics are only feebly represented. The risk of **regulatory capture**, often raised by the regulators themselves, should be discussed in the framework of the review of the ESAs.