8 September 2017

Insurance Europe comments on the review of the Solvency II risk margin

This note is aimed at highlighting Insurance Europe' views on the review of the risk margin (RM) in Solvency II, and is organised in 4 sections as follows:

1. General comments and key positions

The Risk Margin (RM) is one of the layers of the Solvency II total liabilities. It is added to the best estimates of the claims and other liabilities and therefore directly reduces the available solvency capital (own funds). The risk margin is a theoretical concept developed for Solvency II, intended to ensure a failing insurer can transfer its liabilities to a third party if needed. It is not required to cover any actual expected claims or other liabilities (this is covered by the comprehensive best estimate liability calculations) or any claims that turn out to be higher than the expected level (this is covered by the high solvency capital requirements (SCR)).

As a new and theoretical concept, a methodology and calibrations for the RM had to be invented during the development of Solvency II. The RM was never expected to have a very significant impact on a life insurer's balance sheet, but its current level is unexpectedly extremely high. For the entire European industry, according to EIOPA figures, the total RM was €210bn in Q3 2016, out of which €150bn stem from life and composite insurance undertakings and represent more than 45% of the life insurance industry SCR. For certain long-term products the RM can be especially extreme, as such products include pensions paid out in lifelong annuities, whole life insurance, as well as funeral insurance products (very popular in the Netherlands).

€210bn is an enormous amount of capital consumed by the RM and as such is locked out of productive use. Excessive levels result in a waste of scarce capital and limit the capacity of insurers to take risks and grow. Excessive RM will also have a major impact on the costs and availability of certain products, particularly long-term products, to the detriment of policyholders, and could trigger otherwise unnecessary and harmful actions for insurers under pressure from low interest rates.

The excessive size of the RM represents a pan-European issue, of importance to (re)insurance undertakings across EEA jurisdictions. For example, EIOPA's Q3 2016 data for Life business shows very clearly that the RM is higher than 50% of SCR in 4 EEA jurisdictions (ie Czech Republic, Germany, Netherlands, Norway) and between 40-50% in 10 EEA jurisdictions (ie Estonia, Greece, Ireland, Liechtenstein, Lithuania, Luxembourg, Poland, Slovakia, Spain and UK).

On top of the overall size and impact on certain products, the RM is significantly sensitive to changes in interest rates. One of the reasons it is so much higher than expected is that the methodology was never tested for low interest rate conditions. For example, a recent sensitivity analysis showed that a 200bps fall in the risk-free rates can result in the size of the RM doubling.

Insurance Europe believes that **the Solvency II 2018 review should aim to address the excessive level of the RM, the disproportionately large allocation for certain long-term products and the volatility**.

Insurance Europe welcomes that the EC call for advice of July 2016 identified the cost of capital as an area to be reviewed, as the current 6% calibration is much higher than necessary and is a major reason why the RM is excessive. A more appropriate calibration would be 3%.

Beyond the level of the RM, the current design of the RM is also flawed and causes an excessive allocation to certain (long-term) products. This needs to be addressed through an improvement to the formula. This can be achieved within the Level 1 framework and also without increasing work and expenses for undertakings. For example, a "tapering" factor can be applied to the projection of future SCRs for non-hedgeable risks, to reflect risk dependence over time.

2. Evidence on shortcomings of the RM

The RM is a significant layer in liabilities across EU jurisdictions and companies

The following examples originating from country and company specific (SFCR) information publicly available point out that the RM can be very substantial, especially for life insurers.

Company	RM	RM (% of SCR)
AXA Group	€12.4bn	42%
Munich Re Group	€10,0bn	66%
Generali	€7.7bn	33%
HDI	€4.6bn	55%
NN life	€3.7bn	97%
Covea	€2.8bn	47%
Delta Lloyd	€1.9bn	102%
KLP Group (Norway)	€1.3bn	94%

As an additional anecdote, Yarden, a Dutch funeral insurer, saw its SCR ratio falling below its internal 150% threshold, in part due to the RM. Yarden had to de-risk and sell equity and corporate bonds to bring its solvency above its target level.

The RM is excessively large for certain products, regardless of the level of CoC

- Long-term products

The RM particularly impacts long-term insurance business that offers guarantees, such as annuity business. As a consequence of the increasing burden of the RM, firms are moving away from annuities and into business lines (such as unit-linked) that do not attract the same level of RM, and do not pose the same artificial challenges to the Risk Management function that the RM has introduced.

For example, since 2014, seven UK firms have withdrawn completely from the UK open annuity market, citing in part the capital requirements and risk management challenges of Solvency II. This has reduced competition in the market place, and reduced choice for consumers.

For annuity providers, the longevity risk SCR generated by the annuity business is likely to be the most significant non-hedgeable risk in the RM calculation, particularly at long durations where the annuity business is still in force but other lines of business have entirely run-off. It will be particularly sensitive to reductions in the levels of interest rates because:

- The longevity risk SCR is based on additional payments to annuitants beyond their best estimate life expectancy, so the stressed liability cash flows occur many years in the future. This means that the longevity SCR has a very long duration. It increases significantly when interest rates fall.
- The RM is based on projecting the longevity SCR, discounting the values and multiplying by the cost of capital. So when interest rates fall, the increased SCRs are discounted at reduced interest rates.

Hence the Risk Margin is affected twice and as such has a double sensitivity to a fall in interest rates.

- Funeral insurance

In the Netherlands, funeral insurance is a popular product. As the RM may be considered as an allowance for risks that are not taken into account elsewhere, the RM would be expected to decrease when the insurance product comes closer to maturity. However, in its current design for certain types of funeral insurance, the RM is increasing when the insurance product is nearing maturity. The examples below show that for companies offering funeral insurance the RM can be very significant.

Company	RM	RM (%of SCR)
Dela	€682m	83%
Monuta	€254m	67%
Yarden	€185m	110%

- Unit-linked products

The RM is based on a cost of capital approach for non-hedgeable risks, which currently includes the mass lapse risk. In case of companies with predominantly unit-linked business, the existence of a large mass lapse risk is usually closely linked to a large part of own funds being "financed" by the value of future profits. Contrary to equity, however, companies do not usually apply a return requirement on the value of future profits. It can therefore be argued that the current design of the RM tends to overestimate the value of the RM for such companies.

Not only is it unlikely that the reference company, as referred to in Article 38 of the Solvency II regulation, would receive a portfolio with a large value of future profits – and thus a large mass lapse risk – since such a portfolio would be unlikely to end up in a situation with solvency problems in the first place. It can also be argued that such a portfolio, where the required own funds are to a large extent covered by the value of future profits, would not need an additional return requirement, as is implicitly assumed by the current design of the RM.

As possible solution for this problem, Insurance Europe suggest the following: to the extent that it can be shown that the amount of mass lapse risk corresponds to a positive value of future profits in own funds, mass lapse risk should not be part of the risks leading to a cost of capital for the assumed reference undertaking in Article 38. In other words, the mass lapse risk should in those cases be excluded from the RM calculation.

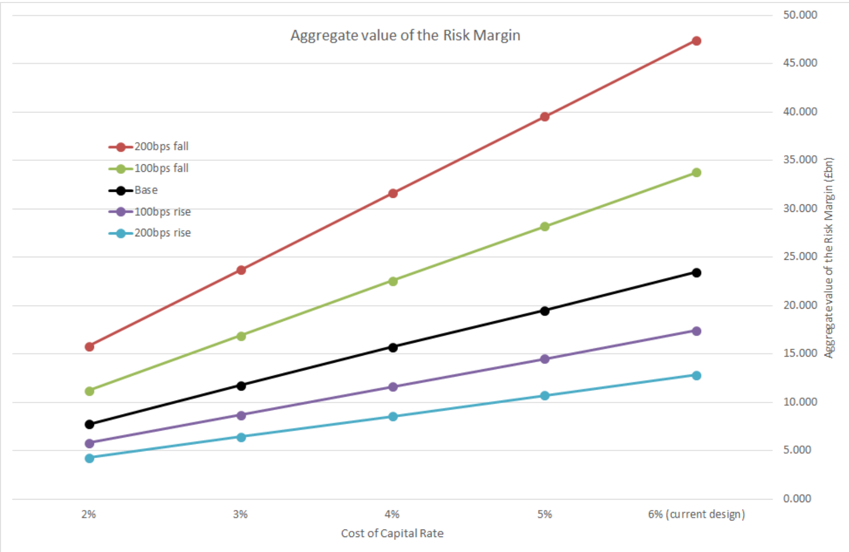
The RM is overly sensitive to changes in risk-free rates, regardless of the level of CoC

Although reduction in the CoC rate reduces proportionally the absolute size of the RM, there is no mitigation of the sensitivity of the RM to interest rate movements. The RM remains volatile to changes in interest rates. For example, a survey[1] gauging the impact of the RM on the Solvency II balance sheet demonstrated how, for several levels of the CoC, the RM would be affected by movements of ±100 bps and ±200 bps in the risk-free rate (see figure 1 below). Specifically:

- If risk-free rates decrease by 100bps, the RM would increase by more than 40%
- If risk-free rates decrease by 200bps, the size of the RM would be more than double

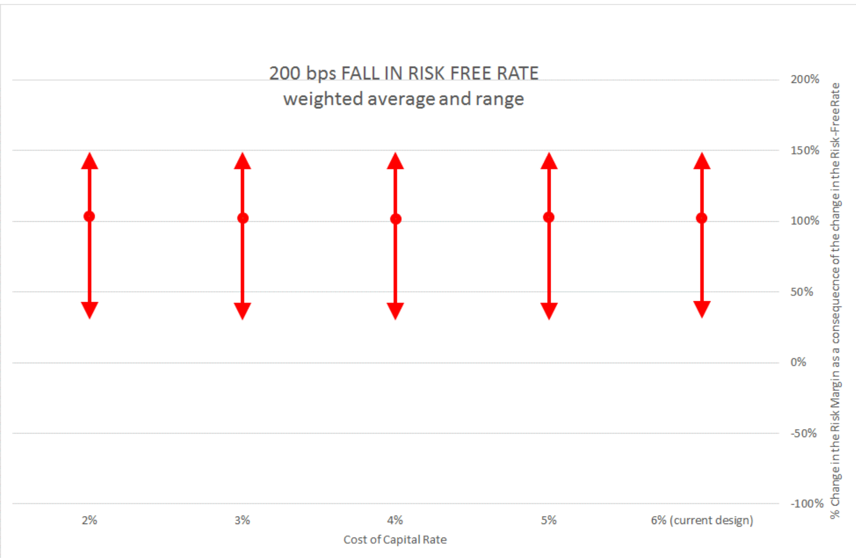
[1] Survey ran by the ABI on 14 companies, representing 75% of the aggregate UK Life RM, on data from year end 2016.

Figure 1: Aggregate size of the RM as a function of the CoC rate, including ±100bps and ±200bps changes in risk-free rate.



The same survey showed that the impact of changes in risk-free rates and the consequent RM volatility vary from company to company, but are on average very significant. For example, Figure 2 below shows that a 200bps downward shock on the risk-free rates can lead to a 150% increase in RM, at all CoC rates. **This emphasises the fact that reviewing only the CoC would still leave significant volatility in the RM.**

Figure 2: Range and average of RM changes for 200bps decrease in risk-free rates



- ***The RM levels are far higher than any reasonable estimation of true transfer costs***

Empirical evidence provided by a large annuity writer shows that there is a significant discrepancy between retaining vs reinsuring longevity risk, driven by the RM. In fact, based on the current conditions, economic neutrality between retaining and externally reinsuring longevity risk would be possible if the RM was reduced by around 75% to 85%. This shows clearly how distorted the RM is from an economic, risk-neutral approach.

3. Potential negative consequences of a limited review of the RM

Longevity risk/long-term products are particularly affected by the design of the RM

As noted above, empirical evidence provided by a large annuity writer shows that there is a significant discrepancy between retaining vs reinsuring longevity risk, driven by the RM.

In addition, insurers find it challenging and difficult to define hedging strategies for the RM, given its volatility and the way it can increase in value rapidly and unexpectedly. The current size of the risk margin also distorts incentives for effective asset/liability matching.

The impact of the RM is significant not only for insurers, but also for reinsurers taking on their books longevity risk. In fact, a decision by an insurer to pass on longevity risk in reinsurance could trigger an arbitrage opportunity between a Solvency II reinsurer vs a reinsurer under the scope of a different/less onerous regulatory regime. More concretely, the RM may make reinsurance under Solvency II for longevity risk more expensive than reinsurance under a different regime.

Wider impacts

Insurance Europe believes that a review of the RM is necessary and needs to be ambitious enough to address both the excessive size and the volatility of the RM. Unless appropriately reviewed, the RM has the potential to impact business decisions in the following negative ways:

- The pricing of new business would need to reflect the size and volatility of the RM, which would have a direct impact on consumers' access to insurance products and serves to worsen the value of long-term products in a low interest rate environment.
- The consumer benefit in profit-sharing products would be negatively impacted.
- Costs associated with interest rate hedging would increase, with potentially direct impact on the pricing of products.
- There would be increasing disparities between interest rate sensitivity in the economic/IFRS balance sheet when compared with the Solvency II balance sheet.

Additional comments

- EIOPA's assessment

The background note EIOPA circulated before the roundtable of 23 May included EIOPA's assessment on the Insurance Europe proposal of varying CoC with the level of risk-free rates. In which EIOPA stated the following: "*The proposed approach may reduce the volatility of the RM for long-term business, but may increase it for short-term business, unless the rate was to vary by term as well as currency*." Insurance Europe believes that this statement is highly doubtful, as risk-free rates across terms and currencies are highly correlated. Against this background, Insurance Europe believes that its proposal on varying the CoC with the RFR will therefore inevitably lead to lower volatility compared to the current CoC calibration.

- Level of Cost of Capital vs comparable bonds

An insurance undertaking, for which the own funds equal the SCR, can be compared to a credit bond with BBB rating. Historically, such credit bonds have had spreads of about 2-3 %, which would be a more appropriate level for the CoC than 6%.

4. Looking ahead

Insurance Europe believes that **the Solvency II 2018 review should aim to address both the excessive level and the volatility of the RM and ensure it is not disproportionately large for long-term products**.

Insurance Europe believes that the **2020 Solvency II review** should discuss and challenge the raison d'être of the RM. Indeed, as noted in the introduction the RM is a theoretical concept, and is not actually needed to cover expected claims or provide protection against higher than expected claims. The need to ensure a failing company can transfer its liabilities if needed is legitmate. However, Solvency II is already designed to ensure that, should an insurer get into trouble, the supervisor can intervene while there is still significant solvency capital left. The most serious intervention point(ie the MCR) was designed so that if a transfer is needed, there is additional money available to ensure a third party can be found to take over the liabilities. The MCR (which totaled €235bn for the industry in Q3 2016) already covers this role and therefore, the RM is not actually needed to ensure customers are strongly protected.