



Mr Michel Barnier
European Commissioner for Internal Market and Services
European Commission
BERL 10/034
B - 1049 Brussels

21 June 2013

Joint PEIF, Insurance Europe, CFO Forum and CRO Forum Response to EIOPA LTGA proposals

Dear Commissioner Barnier,

Solvency II needs to be fit for purpose, enabling insurers to continue to provide long term products to customers and to act as long-term investors in the economy. It should therefore require companies to hold capital against risks they face but not against risks they do not face and should not introduce 'artificial' volatility. It must reflect the long term nature of insurance business and the important role of asset liability management: accordingly measures which move away from actual company investment holdings introduce additional risk and potential inappropriate investment behaviour.

Effective counter-cyclical tools are required under Solvency II to reduce the inappropriate impact of extreme market volatility on insurers and reduce the incentives for procyclical and systemic behaviour in extreme conditions.

EIOPA was asked to assess the impact of a number of measures considered by the Trilogue parties to address the issues associated with insurance products providing long term guarantees and their relative exposure to short term market movements. In this context, EIOPA has conducted a technical assessment and also presented its recommendation in the LTGA report issued on the 14th of June.

The European insurance industry welcomed the decision to carry out an impact assessment to test some of these measures before the finalisation of Solvency II and is ready to continue the constructive dialogue on the long term measures. We remain committed to finding a suitable solution on a timely basis. With regards to the EIOPA report, the industry recognizes that some progress has been made. In particular, we see positive development in the fact that EIOPA confirms the need for a package of measures including a Classic Matching Adjustment, Extrapolation and Transitional. Furthermore, the Volatility Balancer appears to be simple and more predictable than the CCP.

However the industry considers that the conclusions and measures proposed in the EIOPA LTGA report do not address the underlying issues and concerns, particularly the volatility and procyclical incentive features of Solvency II. Hence, the EIOPA proposals as currently designed and calibrated are not a solution.

The mechanism proposed by EIOPA to address spread volatility will not address the issue

EIOPA introduces a concept of Volatility Balancer. The Volatility Balancer methodology contains inconsistencies, the design is flawed and calibrations so onerous as to make it ineffective.

- a) The Volatility Balancer should not only apply in Best Estimate calculations but also in Solvency Capital Requirement (SCR) calculations.
 - EIOPA's proposed treatment would introduce inconsistency and more volatility in the Solvency II ratio. The SCR is by definition a stress of the Own funds (Value at Risk with a shock at a 99, 5% confidence level). This is conceptually inconsistent not to use the same curve for the calculation of the two elements of the Solvency ratio, the Own Funds and the SCR.
- b) The Volatility Balancer as proposed by EIOPA only amounts to 20% of the spread of a reference portfolio
 - This severe 80% haircut is both arbitrary and makes the mechanism ineffective.
 - Starting from the 2011 situation, higher spread increase of some national government or corporate bonds would deteriorate the Solvency II ratio. The 20% application ratio would surely be far too low to be an efficient counter cyclical measure. It does not offer any protection against pro-cyclical behaviours in times of crises where insurers would necessarily sell their assets and review their asset allocation to improve the Solvency II ratio.
 - Based on preliminary analysis, we do not understand EIOPA's results stating that the Volatility Balancer as currently designed and calibrated (around 25bps at year-end 2011) would have the same effect as a 100bps CCP, with a capital charge on CCP.
- c) The adjustment of national government bond spreads is needed. However the proposed use of an adjustment with very high trigger levels means that significant volatility would remain.
 - The adjustment of national government bonds spread is subject to a trigger. It will make this adjustment non predictable, non-permanent, and will introduce cliff-edge effects. It will increase the volatility of the Own Funds and will not encourage companies to continue to invest in their national government bonds in countries that are experiencing a widening of spreads.
- d) The volatility balancer should be applied to the risk-free interest rate term structure used to calculate the Best Estimate
 - We do not see any justification for EIOPA's suggestion to present the measure as a 'special' own funds item and hence it should be fully recognised as Tier 1 capital. Additionally, "special" own funds are new to the Solvency II framework and lack any definition. It is important that the volatility balancer is recognised as a valid long term measure.

Remaining restrictions on Classic Matching adjustment significantly limit the effectiveness of the measure

We are pleased that EIOPA is in favour of implementing the classic MA recognising the economic justification and effectiveness to better reflect the risks and the balance sheet. The extension of its scope to cover products with immaterial mortality risk is a significant improvement. However, the proposal still includes strict criteria including asset restrictions, limitation to treatment of BBBs & below, ring fencing and inclusion of artificial floors for the fundamental spread (75% Long Term Average Spread in corporate bonds and 30-40% current spread in government bonds), which are not economically justified and which will lead to an ineffective measure as shown by the LTGA results. Hence it will not address the outstanding issues for matched insurance products (including annuities) in certain countries.

EIOPA recommended change in the methodology for extrapolation will increase volatility

EIOPA advises to select a convergence period that is significantly longer than 10 years (e.g. 40 years) albeit a consensus on a shorter convergence period has been reached. A shorter convergence period can be considered as an appropriate tool to limit volatility of technical provisions and we would therefore suggest refraining from choosing a longer convergence period. The extrapolation should therefore start at year 20 (for the Euro) and have a convergence period of 10 years.

Transitional measures are welcomed and needed but must be carefully considered

We acknowledge that EIOPA has started tackling some of the aspects regarding transitionals and also expressed the potential need for several transitionals. We also believe that, as shown in the LTGA, transitionals are needed to ensure a smooth transition from Solvency I to Solvency II.

The industry is supportive of exploring alternative transitional arrangements as solutions which in order to be effective should have a sufficient duration. It is important that these measures are applicable to different types of existing business (taking into account local market specifics) whilst avoid accentuating existing market differences and arbitrary decisions by local regulators. In our view, at least one of the transitionals should be 'dynamic' and have sufficient duration – the tested 7 years should be substantially extended. Additionally, such transitionals should be fully Solvency II compliant and be applicable in best estimate calculations, rather than being an adjustment to Own Funds.

The credit adjustment to the swap curve (-35bps as at end of 2011) which first defined in the LTGA is arbitrary and will create an artificial gap between assets and liabilities

The reference curve for the risk free rate should be the swap curve versus Euribor 6 months without any adjustment. Bonds are issued in primary markets on this basis (midswap Euribor 6 months + the credit spread) and bonds are subsequently quoted in secondary markets on this basis as well. In order to have a consistent asset/liability approach, the reference curve used to discount liabilities must be the same curve as the one which is used for investments on the asset side. Moreover, a -35bps adjustment at end of 2011 would completely offset the benefit of the Volatility Balancer.

The absence of effective and fully recognised counter-cyclical mechanisms for insurers will reduce the capacity of the Insurance sector to play a stabilising role in crisis times.

Conclusion

Without changes to design and calibration of the proposed measures, an important opportunity to create effective counter-cyclical tools would be missed and the capacity of the insurance sector to play a stabilising role in crisis times put at risk.

This puts into question an insurer's dual role as a long term investor in the European economy and a provider of long-term savings and retirement solutions. It will hinder the insurance sector's role as a pro-active contributor to the European economic growth recovery.

We believe a number of substantial changes in the proposals and their calibration (see above) are still required to enable the measures to be effective. The industry is ready to continue the constructive dialogue on LTG measures based on EIOPA's proposal and to demonstrate how the measures can be improved.

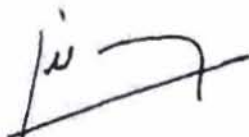
Yours sincerely,



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