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Towards an amendment to Solvency II?

EIOPA, the European Insurance and Occupational Pensions Authority, has recently performed a comprehensive review of the standard formula methodology under Solvency II. Some recommendations may have a significant impact, for instance the new methodology with respect to the required capital calculation for interest rate risk. We discuss EIOPA's proposals and analyse the possible impact on European insurance companies. All advice has been sent to the European Commission at the end of February 2018 and implementation is possible by 1 January 2019 at the earliest.

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TIMELINE

The Solvency II Directive was adopted in 2009 and amended on 16 April 2014 in the so-called 'Omnibus II Directive'. On 10 October 2014, the European Commission adopted the implementing rules for Solvency II. On 20 September 2015, the European Commission amended this regulation, in particular the capital requirements for different categories of assets. All of these texts entered into force on 1 January 2016.

After a consultation phase during 2017, EIOPA published a first set of advice on 30 October 2017. A second, very comprehensive, set of advice was published on 28 February 2018.[1] All advice has been sent to the European Commission at the end of February 2018. Implementation is possible by 1 January 2019 at the earliest.

INCREASED SOLVENCY CAPITAL REQUIREMENT FOR INTEREST RATE RISK

EIOPA mentions that the current approach for calculating the solvency capital requirement (SCR) for interest rate risk leads to a severe underestimation of the actual risks. For example, in reality interest rates have moved more than in the SCR stress scenario (which should only happen once every 200 years). The current approach also fails to stress negative rates, although negative rates can continue to decrease in practice. Users of internal models for the SCR calculation typically adopt alternative, more realistic, approaches in practice. This has led to a broad consensus in the insurance industry that the current standard approach has severe shortcomings.

The new approach proposed by EIOPA is illustrated in Figure 1. This figure shows the base risk-free euro curve published by EIOPA at the end of January 2018 (the central blue line) and the (current and new) stressed interest rate curves. If we now compare the old and the new methodology (so dark blue versus green line, and yellow versus red line), we see that the applied stress is much larger for the decreased interest rates. The additional stress is approximately 64 basis points (averaged over maturities from 1 to 60 years) in this case. The effect is smaller for the increased interest rates: on average 15 basis points more. The impact is especially large for short and intermediate maturities.

EIOPA estimates that the new approach could deteriorate the solvency ratio of life insurers who are still exposed to the low yield environment by about 14%-points. Given the potentially big impact of these changes, EIOPA therefore advises that the new approach is gradually implemented over a period of 3 years, in particular for the downward shock. These changes could thus well lead to an increased focus on interest rate hedging, because – ceteris paribus – interest rate risk will be penalized more severely.

TREATMENT OF GOVERNMENT GUARANTEES (LIKE NHG) FOR RESIDENTIAL MORTGAGE INVESTMENTS

On another note, EIOPA also advices to adjust the treatment of Dutch residential mortgage loans which are guaranteed by the National Mortgage Guarantee scheme ('Nationale Hypotheekgarantie' or NHG).

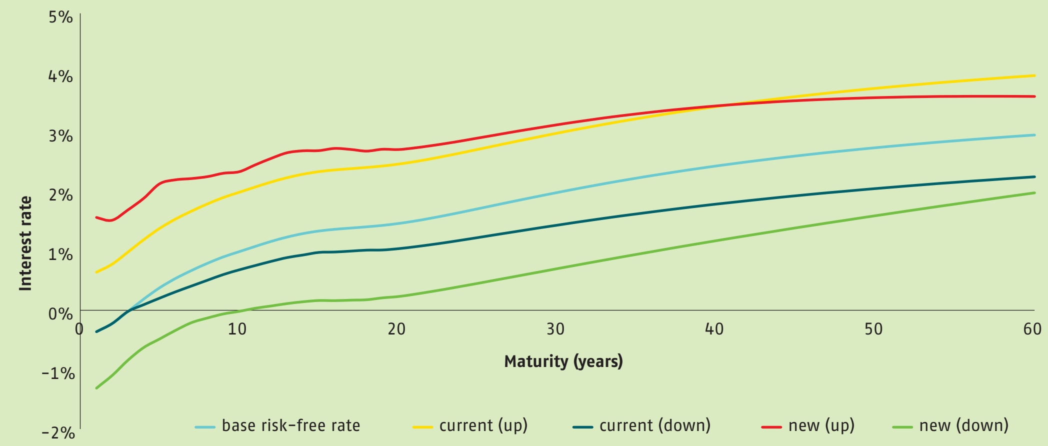

Figure 1. Impact of the proposed new interest rate risk methodology for the risk-free euro rate (as of 31 January 2018). Source: EIOPA, Aegon Asset Management.

The NHG scheme is administered by the Homeownership Guarantee Fund (Waarborgfonds Eigen Woningen, or WEW). The WEW guarantees approximately €190 billion in mortgage loans.

The NHG scheme provides a partial guarantee. Currently, such a partial guarantee is not recognized under Solvency II, whereas partial guarantees are accounted for under Basel III. EIOPA now advices to recognize partial guarantees when the counterparty risk module is used for residential mortgages. This would further reduce the required capital for Dutch NHG mortgages. The attractiveness of Dutch NHG mortgages under Solvency II thus increases when EIOPA's advice is implemented.

TREATMENT OF REGIONAL GOVERNMENTS AND LOCAL AUTHORITIES

EIOPA also wishes to harmonise the treatment, in terms of credit risk, of regional governments and local authorities (RGLA) under Solvency II and Basel III. Synchronising these lists could have a major impact for some countries. The French regions, départements and communes are for example eligible under Solvency II to a shock of 0% in the credit risk module. However, in the banking context, the same exposures are treated with the full capital charge for credit risk. So if in the harmonization process the Basel III list becomes leading, the capital charge for these French RGLA will increase under Solvency II. For Finland, Portugal and Poland there can also be some impact. For the other countries, there is already alignment between the two sets of regulations and there should not be any effect.

EIOPA also advices to treat guarantees of RGLA similarly as guarantees by the central government. Again, this would be a similar approach as under Basel III. Since guarantees of the central government of member states are solvency free, this would imply that guarantees by RGLA also become solvency free.

LOSS-ABSORBING CAPACITY AND DEFERRED TAXES (LAC DT)

Solvency II is a post-tax supervision framework, in the sense that Solvency II losses also result in fiscal losses. Such fiscal losses can result in tax reductions if fiscal profits are available to utilize/offset these fiscal losses. Because the Solvency II required capital calculation focusses on a very negative stress scenario, the mitigating impact of taxes can be substantial. EIOPA signals in the first advice that supervisors have divergent practices to assess how likely future profits are, in order to demonstrate the probable utilisation of LAC DT. In the second advice, EIOPA therefore aims to increase convergence in supervisory practices – and thus capital requirements – for similarly risky insurance firms. This is done by discussing nine different key principles that should be used to align the supervisory practice.

CONCLUSIONS

EIOPA has performed a comprehensive review of the current Solvency II methodology. Implementation is possible by 1 January 2019 at the earliest. Some recommendations may have a significant impact on the solvency ratio, especially the new proposal with respect to the required capital calculation for interest rate risk.

EIOPA also proposes to acknowledge the risk-mitigating effect of an NHG government guarantee for Dutch mortgage loans. The attractiveness of Dutch NHG mortgages under Solvency II will increase in this case. Regarding the treatment of regional governments and local authorities, EIOPA advises to use a similar approach as under Basel III.

EIOPA also concludes that supervisors have divergent practices to assess how likely future profits are, in order to demonstrate the probable utilization of deferred taxes. EIOPA therefore proposes several principles that should be used to further align the supervisory practice. ■

1 – See https://eiopa.europa.eu/publications/eiopa-consultations for both sets of advices.