Amundi
ASSET MANAGEMENT

A more restrictive capital requirement for insurers in 2019?

Solvency 2

The European Commission wants to re-examine the methods, assumptions and parameters used to calculate the SCR with the Standard Formula, drawing on the experience gained since 2016.

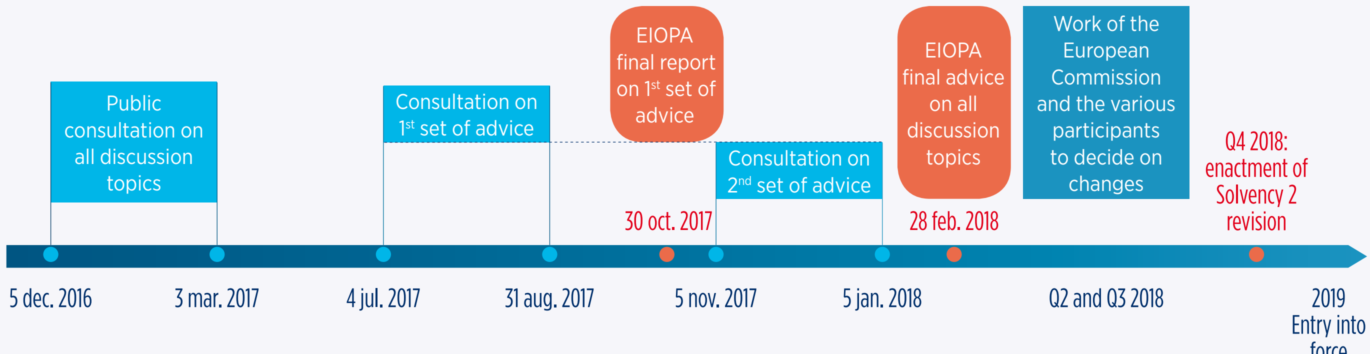
Several modules will be impacted by this review: market risk, premium and reserve risk, and mortality risk.

A preliminary review of the Solvency 2 regulatory framework is scheduled for 2018.

After an initial public consultation launched in early December 2016, EIOPA divided the discussion topics into two sets.

The first set gave rise to a final report at end-October 2017 and the second to a consultation that ended in early January.

EIOPA will submit a final technical advice to the European Commission on both sets of discussion topics by 28 February 2018, and the Commission will then continue its work to finalise the new provisions.



Source: Amundi AM, data as of end-December 2017. Information given for indicative purposes only, may change without prior notice.

EIOPA's final advice on set 1 includes several recommendations with a positive impact on the calculation of market SCR

The changes described in this section are a summary of the propositions made by EIOPA. The European Commission may subsequently make its own changes.

Economic hedging positions for market risk eligible for recognition as risk mitigation techniques to reduce the SCR have been expanded.

For futures and other listed instruments, contracts for the month in progress (or with subsequent maturity dates) may be included as risk mitigation instruments. OTC contracts will initially have to have a maturity greater than or equal to one month.

By eliminating the constraint of using hedges with a maturity date of more than three months, EIOPA is taking into consideration certain business model practices that favour short-dated maturities, which are usually more liquid for portfolio protection purposes.

Furthermore, it will be possible to adjust hedges due to an increase/decrease in the amount of the hedged position,

- either on a weekly basis,
- or more often, depending on the predefined rule governing the variation of the hedged exposure; for example, daily adjustment if the exposure varies by more than 5%.

Material differences remain regarding the treatment of exposures issued (or guaranteed) by regional governments and local authorities (RGLA), where they are held by banks or insurers.

EIOPA has established a detailed comparison of the provisions set forth in the Delegated Regulation for the application of Solvency 2 and the existing prudential requirements for banking activities (Directive 2013/36/EU (CRD) and Regulation (EU) No. 575/2013 (CRR)).

1. SCR : Solvency Capital Requirement.

In its October 2017 report, EIOPA confirmed that certain differences are justified. EIOPA confirmed that there is no specific categorisation for RGLA exposures in prudential regulations for insurers. However, in banking regulations, these exposures are subject to an intermediate treatment between that of government bonds and that of corporate bonds.

Certain changes lowering credit and counterparty SCR are recommended in the report:

- Incorporating partial guarantees from Member State central governments (or RGLA considered as equivalent to the central government) in the assessment of loss-given default on a mortgage loan[2],
- Treating guarantees from RGLA listed in Implementing Regulation 2015/2011[3] as equivalent to Member State central government guarantees,
- Aligning the treatment of exposures to RGLA not listed in Implementing Regulation 2015/2011 with the treatment of bonds issued by non-EU Member State governments (in the currency of the issuing government).

The need to rely on credit risk assessments issued by rating agencies is somewhat relaxed for the calculation of the market SCR within a framework limited to certain insurance undertakings.

If the conditions of Article 88 of the Delegated Regulation, laying down the principle of Proportionality, are verified , EIOPA recommends using a simplification.

This simplification may only be used where the following three criteria are met:

- the insurer has nominated one (or more) External Credit Assessment Institutions (ECAI) covering at least 80% of its whole debt portfolio,
- the remaining asset classes and investments not covered by nominated ECAI are bonds or similar investments that provide a redemption payment on the date of maturity or before, as well as a return payment, in the form of a regular coupon payment on a fixed or floating interest rate basis (loans, structured notes and collateralised securities are excluded),
- these assets do not cover liabilities that provide mechanism of profit participations, or unit/index-linked liabilities or liabilities where the matching adjustment is applied.

If all these conditions are met, the insurer may use a CQS of 3 (i.e. the lowest Investment Grade level) to calculate the credit SCR for all assets not covered by nominated ECAIs. However, where there is evidence that the average risk profile of the assets or a material part of them is below a CQS of 3, the simplified calculation would not be appropriate.

In general, EIOPA does not support the development of internal credit assessments as an alternative to ECAIs. The question of debt not covered by nominated ECAIs is nevertheless examined in the second set of advice.

However the changes considered in set 2 may lead to a material increase in the SCR generated by interest rate risk

The second set of advice was submitted for a consultation which ended on 5 January. EIOPA will issue its final report at end-February and the European Commission will then be able to make adjustments. As a result, the changes considered in the consultation are likely to be significantly adjusted.

In EIOPA's view, in a low interest rate environment, the current configuration of the standard formula underestimates interest rate risk.

As the review of the interest rate risk sub-module was not subject to a European Commission request for advice, the supervisors suggested making an adjustment to the sub module.

After revising the definition of the Ultimate Forward Rate in 2016, which tends to decrease the solvency ratio, by increasing the valuation of very long-term commitments, the change considered by EIOPA could further reduce the ratio by increasing the capital requirement for market risk.

EIOPA examined several approaches to alter the configuration of interest rate shocks for the up scenario and the down scenario.

Proposition A

The first method considered is to increase the intensity of shocks by applying minimum shocks of +2% and -2% to the current relative variations for the up and down scenarios, respectively, for maturities of less than 20 years. After 20 years, the absolute minimum shocks of 2% would be phased out linearly to reach 0% at 90 years.

A maturity-based floor would nevertheless be established for the interest rate stemming from the down scenario: -2% for the 1-year rate, -1% for maturities over 20 years, with the floor between 1 and 20 years defined by linear interpolation.

Proposition B

EIOPA has also considered a second, less adverse method, involving the use of the lowest of the following two shocks:

- the 2% absolute shock and its conditions of application in Proposition A, and,
- an affine model, calling for an increase in the relative variation included in the current regulation, by adding an absolute shock of 1.4% for the up scenario and -1% for the down scenario.

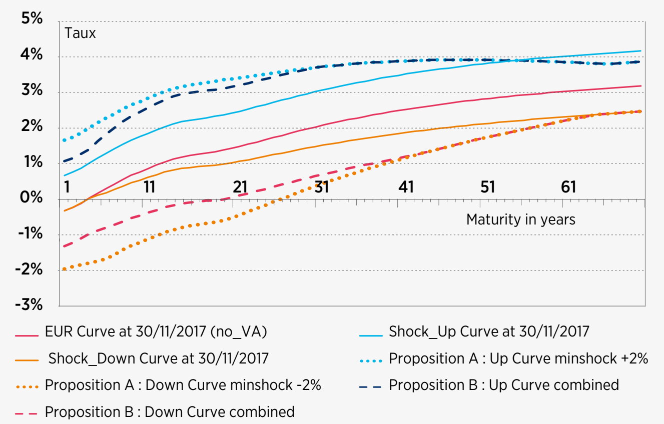
2. Provided that 1) the criteria on mortgage loans set forth in Article 191 of DELEGATED REGULATION (EU) 2015/35 are met and 2) the conditions for incorporating risk mitigation techniques set forth in Articles 209 to 215 (except the word "fully") of this same regulation are observed.

3. COMMISSION IMPLEMENTING REGULATION (EU) 2015/2011 includes, for the various EU Member States, the list of RGLA to whom are to be treated as exposures to the central government of the jurisdiction in which they are established.

Under this approach, additional shocks (+1.4% and -1%) would only be applied up to 20 years. For longer maturities, they would be gradually phased out to reach 0% at 90 years.

In the current regulation, only the up scenario includes the application of a minimum variation of 1% and negative rates are not subject to down shocks. It is clear that in the current low interest rate configuration, the proposals presented in the consultation result in significantly more intense shocks, particularly on maturities under 20 years.

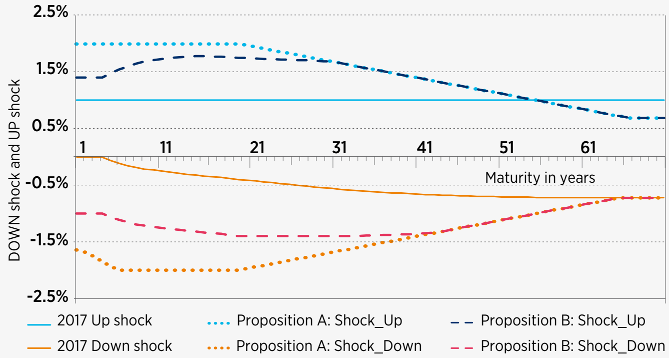
EUR Yield Curve at end-November 2017 and stressed curves (UP and DOWN)



Source: EIOPA, Amundi AM calculation, data as of end-November 2017.
Given for illustrative purposes only.

Insurers with mismatched assets and liabilities would be impacted, particularly if they are exposed to the risk of interest rate decreases. Maturity mismatches would also have a more adverse impact than in the current regulation.

EUR interest rate shocks at end-November 2017 (UP and DOWN) based on the current regulation and EIOPA Propositions



Source: EIOPA, Amundi AM calculation, data as of end-November 2017.
Given for illustrative purposes only.

This issue could end up being highly debated in the coming months.

EIOPA has opened the door to internal assessments for certain types of debt not covered by nominated ECAIs, but the process is fairly complex to implement.

EIOPA has considered an internal assessment approach to define the Credit Quality Step (CQS) for investments in non externally rated corporate senior debt.

Infrastructure and financial sector debt would be excluded from the scope and the company would have to be domiciled in the European Economic Area. The assessment of the issuer's creditworthiness could be based on several financial ratios (not yet defined at this point) and the insurer would also have to analyse the yield on unrated debt in its portfolio compared to average yields calculated on different indices for rated debt.

Surprisingly, EIOPA has only considered the internal assessment approach for the attribution of a CQS of 2. The internal assessment option would also be limited to 5% of all investments

EIOPA is seeking to define criterias to serve as a basis for assigning the same capital requirement for listed equities to unlisted equities.

EIOPA has proposed an initial set of qualitative and quantitative criteria authorising the application of the Type 1 Equity shock instead of the current Type 2 Equity shock to Private Equity (PE) investments.

The qualitative criteria restrict the universe to ordinary corporate equities, issued by companies, established in the EU/EEA that are larger than small-sized Enterprises. Equities issued by financial institutions are excluded. EIPOA has added a quantitative criterion based on balance sheet information available from companies.

Indirect investments via PE funds or funds of PE funds would have to observe principles of diversification, transparency, governance and supervision. Moderate leverage may be accepted.

While stressing the difficulties created by limited historical data, EIOPA clarified that the criteria under consideration were preliminary at this point, that it was in the process of expanding its review and that the final proposition may be significantly different.

EIOPA recommends expanding the scope of positions included in the counterparty risk module by incorporating all exposures to derivatives, whether or not they are included in a risk mitigation strategy.

As regards financial risk mitigation techniques, EIOPA is considering taking hedging strategies into account on a broader basis.

In practice, a risk mitigation technique can use several derivative instruments and the current calculation of loss-given default on a solo derivative instrument does not always properly reflect economic risk.

4. "A simplified calculation shall not be considered to be proportionate to the nature, scale and complexity of the risks where the error ... leads to a misstatement of the Solvency Capital Requirement that could influence the decision-making or the judgement of the user of the information relating to the Solvency Capital Requirement, unless the simplified calculation leads to a Solvency Capital Requirement which exceeds the Solvency Capital Requirement that results from the standard calculation."

5. CQS: Credit Quality Steps.

Whenever there are offsetting agreements, loss given default must be calculated on the counterparty, taking into account the value of all derivatives, the SCR savings generated by the hedge and the collateral received.

EIOPA is considering expanding the data grouping approach for SCR calculations on investments in funds.

Assets held to meet unit-linked commitments would no longer be taken into account when verifying the 20% limit accepted for the data grouping approach to calculate the SCR generated by holding units of collective investment undertakings or funds.

If data groupings still have to be applied in order to calculate a cautious SCR, a lower degree of granularity would be required. In particular, the use of an average CQS might be acceptable, if it is cautious.

If the look-through approach cannot be applied, the SCR could also be calculated based on the fund's last known asset allocation, provided that the fund is managed in accordance with this allocation.

Conclusion

No major changes were made to Solvency 2 in 2017. The regulator focused more on improving the implementation quality of the existing framework.

For listed insurers, or insurers consolidated in a listed group, the big event of the year was the May 2017 publication of the new accounting standard on insurance contracts (IFRS 17). IFRS 17 will not take effect until 2021, and this standard on liabilities will undoubtedly call for large-scale adaptations to information systems.

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