Hot Topic

EIOPA publishes interim technical guidelines and launches stress testing exercise

FS Regulatory Centre of Excellence

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Summary

On 30 April 2014, the European Insurance and Occupational Pensions Authority ("EIOPA") published the detailed technical specifications which will be used as the basis for Solvency II interim reporting during 2014 and 2015. These give a crucial early insight into the likely direction of travel towards the final Solvency II requirements.

In the UK, the PRA has already warned that these technical specifications will also form the basis of a UK-wide survey, starting in May, of both Standard Formula and Internal Model firms to compare SCR and ICA differences.

The Danish FSA has not stated its plans.

Parallel with the publication of the technical specifications, EIOPA also formally launched a stress testing exercise for certain large firms, which will be conducted in Q2 and Q3 2014, with results expected in November 2014.

It should be noted that the interpolation of the interest rate curve is 40 years for Denmark in the stress test (going from 20 to 60 years) towards the ultimate forward rate at 4.2. Today, the Danish interest rate curve is interpolated over 10 years (from 20 to 30 years) against the 4.2.

The most significant change to the ***technical specifications*** in comparison to the ones used for the long-term guarantee assessment ("LTGA") in January 2013 is the inclusion of fundamentally new requirements concerning the long-term guarantee package. While the technical specifications have increased transparency in some areas, a number of significant unanswered questions remain.

Addressing these questions is vital to assessing the impact of the long-term guarantee package. Firms will be required to develop a "house view" on key areas of judgement such as the admissibility of callable bonds/mortgage assets and the permitted extent of cash flow mismatching. Firms will have to decide on and present to the FSA/EIOPA such assumptions. It remains unclear whether the EIOPA stress test kick-off meetings in May will address all issues sufficiently.

Given the significant financial impact of these key judgements, firms should consider obtaining external support and assurance to ensure that their interpretation and adopted approach are consistent with emerging industry best practice.

The technical specifications have also been updated in line with other changes resulting from the finalisation of Omnibus II and the latest draft delegated acts. In many cases, the changes from January 2013 are minor, although in some areas (such as changes to the standard formula capital charges for securitisations) they are more substantive.

With firms about to begin the IMAP process, many will consider the need for assurance and validation in relation to their **stress testing results** prior to submission to the regulator – getting this right the first time is crucial.

Background

On 30 April 2014, EIOPA published the long awaited technical specifications which are to be used across Europe in the period prior to Solvency II "going live". These will form the basis of the Solvency II balance sheet for interim reporting at YE14 and Q3 2015. In the UK, the PRA will use it for the data exercise over 2014[1].

While not a formal part of the Solvency II legislation, these technical specifications give the clearest indication yet around the likely direction of travel for the delegated acts and implementation of technical standards that will make up the rulebook.

Together with the publication of these technical specifications, EIOPA also launched a formal stress testing exercise. The last stress testing exercise conducted by EIOPA took place in 2011, when Solvency

II legislation was much less advanced and firms were much less prepared. Therefore, the results of the new stress testing exercise will be much more insightful for both firms and regulators as they plan paths towards Solvency II implementation at 1 January 2016.

Launch of 2014 stress testing exercise

EIOPA has launched a formal stress testing exercise which will be carried out during 2014. This exercise will involve participants from both life and general insurance chosen by the Danish FSA that aim to cover 50% or more of the respective markets. Participation is expected to be mandatory.

The stress testing exercise began formally on 30 April and firms will have until 11 July to submit their results to the regulator. The regulator will validate the submissions during July and September, and the test results are expected to be issued in November 2014. EIOPA will not disclose individual company results but will probably focus on key themes for each country/market sector instead.

The stress testing exercise comprises two modules:

1. A core module which, unlike the 2011 stress testing exercise, is scenario-based
2. A low yields module focusing on assessing the impact on the insurance sector of a prolonged period of low interest rates

Requirements of the core module

The core module will involve a recalculation of the Solvency II base balance sheet (but not the SCR, which is assumed to remain unchanged for simplicity) under two adverse market risk scenarios as well as several stand-alone insurance risk stresses.

The first market risk scenario is intended to represent an **equity market stress** which spills over into other market segments. The second scenario represents a corporate bond stress doing likewise, and both involve serious effects on sovereign debt yields in certain EU member states.

The life insurance stresses are stand-alone stresses and assess the impact of shocks to longevity, mortality and mass lapse scenarios, each at 1 in 100 and 1 in 200 levels.

The general insurance scenarios assess the sensitivity to **five defined catastrophe events**. These are; Northern European windstorm, US hurricane, Turkish earthquake, Central and Eastern European flood and an airport crash event. Insurers need only to report results for scenarios they are exposed to. For each of the five scenarios, EIOPA has estimated the aggregated market insured loss to assist in the stress testing.

The knock effect on reassurance recoveries is also to be reported so EIOPA can consider the resilience of the reinsurance sector.

EIOPA's approach to developing these combined market risk scenarios **is simpler than in the past** – for the 2011 exercise, EIOPA prescribed an approach involving the use of univariate stresses and a correlation matrix. For the 2014 exercise, EIOPA has defined two scenarios in which the stresses are applied simultaneously to give a combined market risk event. This is similar in approach to the scenario analyses used by boards to test and compare their business resilience and their modelled SCR.

The core module will be performed at the "highest level of insurance consolidation", meaning at **a group level**. EIOPA has specified that national regulators should ensure that at least 50% of market coverage is achieved, making it very likely that the main part of the largest and medium-sized insurance groups will be required to participate.

Requirements of the low yields module

Along with the core module, EIOPA is also running an assessment to consider **the impact of a prolonged period of low interest rates on the insurance sector.**

In their 2013 report titled "Opinion on Supervisory Response to Prolonged Low Interest Rate Environment", EIOPA committed to performing an exercise to assess the "scale, scope and timing of risks" arising from a low interest rate environment – this stress testing exercise will meet this commitment.

The module will involve testing the impact of **a Japanese style low interest rate curve as well as an inverted yield curve.** Insurers will have to supply both the balance sheet impacts as well as the underlying asset and liability cash flows.

This has been set up as a separate module because EIOPA expects that the list of participants is different. The module focuses on blocks of business which are most exposed to interest rate risk, particularly annuities and contracts with investment guarantees.

Participation will be on a solo level, meaning that multinational groups may face having to complete a group submission for the core module as well as several individual entity submissions for the low yields module. The low yields module could also capture niche insurers such as bulk annuity specialists who might not otherwise be the focus of the core module.

The importance of getting it right

With the Solvency II go-live date on the near horizon and updated Danish requirements for solvency ("*Ensartet beskyttelse af forsikringstagerne*") a reality, demonstrating a strong understanding of results and a strong capital base will become increasingly important for firms. This is particularly true given the vast amount of communication with the regulator, through the EIOPA stress tests, the interim reporting, the FSVS reporting (reporting of S1,75), internal planning and ORSA projections as well as discussions with external analysts.

On this background, many firms will consider obtaining external assurance for their EIOPA stress testing submissions, particularly the firms entering the internal model approval process ("IMAP") during 2015. It would otherwise be difficult to communicate late changes or errors in the stress testing submission, potentially undermining the strength of a firm's IMAP submission.

Publication of Solvency II technical specifications

With Omnibus II having been agreed in mid-March this year, firms now await the delegated acts and implementation of technical standards to provide details on remaining areas of subjectivity and uncertainty. It is within this context that firms have eagerly awaited the publication of the interim technical specifications to get an indication of where the final regulations are likely to end up.

The published technical specifications will be used as the basis for Solvency II interim reporting during 2014 and 2015. Noting that these represent the 14/03/14 private draft of level 2, EIOPA has also added a clear caveat stating that the technical specifications are only intended to provide a basis for interim reporting. Nonetheless, it would appear a reasonable assumption that they represent the latest thinking and give a strong indication as to the likely direction of travel.

On **assets and other liabilities**, the details include a clarification that defined benefit pension schemes should be measured at their IAS19 value, previously subject to uncertainty, and that deferred taxes should be recognised under IAS12 – with the recent and helpful UK PRA supervisory statement providing guidance[1].

On **technical provisions,** in many areas, the details published have not changed significantly from the technical specifications used for the LTGA in January 2013. This is likely to be met with mixed responses by the industry – while firms will be relieved that whole-scale changes to existing internal models and methodologies are not required, many will also be disappointed that no clarification has been provided on key areas of uncertainty.

In particular, the technical specifications do not provide any more detail on the key qualifying criterion for the matching adjustment, most notably the admissibility of certain assets such as callable bonds/mortgage assets, and the extent of cash flow matching required. Firms will have to develop their own "house view" on key areas of uncertainty unless the EIOPA Q&A process for the stress tests can tease some elements out. It may also be worth it for firms engaging with the FSA at an early stage to determine whether any additional guidance will be provided.

Moreover, firms will be disappointed that no concessions appear to have been made on the issue of contract boundaries – there were recent speculations within the industry that the rules might be amended to allow recognition of future profits which are expected to arise from unit-linked pensions business. However, the substance of these regulations remains unchanged suggesting that the industry's lobbying has not been successful.

There have been more substantive changes to the technical specifications in some areas such as the standard formula capital charge for securitisations. Firms will have to perform an exercise to review the technical specifications in detail and assess the implications of key changes.

The most fundamental changes to the technical specifications are connected to the discount rate. This was expected, as the long-term guarantee package was only agreed in March 2014 and the technical specifications provide insurers with more details on how the package of measures should be applied. Although the level of detail provided will disappoint many, some clarifications which should be helpful to insurers have been provided.

Matching adjustment

The technical specifications have not provided much new detail as regards the interpretation of the matching adjustment requirements – these appear to just replicate the Omnibus II text. Therefore, insurers will have to develop their own views for interim reporting on key areas of judgement such as diversification, how to approach asset portfolios not yet reorganised for all criteria and stressing the matching adjustment within an internal model.

Given the significance of these issues and the material impact that an inappropriate judgement could have on overall solvency, many firms will consider seeking external support and validation to ensure that their interpretations of key issues are consistent with emerging industry practice.

The technical specifications do provide further clarity on a potential loss of diversification credit between a matching adjustment portfolio and the rest of the business. The present main industry view in the UK is that, although standard formula firms are likely to lose diversification credit, internal model firms could make an argument for retaining nearly the entire diversification benefit. However, the new technical specifications bring this argument into doubt – these suggest that even for an internal model firm, the notional SCR for the matching adjustment book of business should be calculated "*as if the undertaking pursued only*

[1] http://www.bankofengland.co.uk/pra/Documents/publications/policy/2014/solvency2deferredtaxcp-14.pdf

business included in the matching adjustment portfolio". The rules also require that own funds are adjusted to reflect the restrictions caused by the matching adjustment portfolio.

This is clearly a very important point, and we expect that firms across Europe will continue to lobby heavily for a more favourable application. However, firms should also consider the amount of capital potentially "at risk" should this interpretation remain unchanged, as well as possible strategies for mitigating the impact.

Volatility adjustment

The newly published technical specifications do not provide much more clarity around the volatility adjustment because it is already relatively well understood and attracts relatively few issues of interpretation.

One of the main outstanding questions was related to the composition of the reference portfolio upon which the volatility adjustment would be based – however, the technical specifications remain silent on this point. No further clarity has been given, with the volatility adjustment based on the same reference portfolio as used for the LTGA in January 2013. Firms will be keen to get more details on this in order to, more meaningfully, anticipate changes in the volatility adjustment.

The final volatility adjustment regulations within Omnibus II were much more generous than the measure which had originally been suggested within the LTGA report – the volatility adjustment increased from 20% to 65% of the risk-adjusted spread. Given this, the volatility adjustment specified by EIOPA for YE13 was expected to increase significantly from the 17bps in the UK and 25bps for Germany which had been suggested within the LTGA report for YE11, even after allowing for the partial offsetting effect due to a narrowing in credit spreads since YE11. Firms will therefore be surprised to find that the volatility adjustment provided by EIOPA for YE13 is only 19bps for the UK and 22bps for Germany (1 bps for Denmark).

EIOPA has not explained why the volatility adjustment is not much higher (even allowing for the impact of a narrowing in credit spreads). This will be an area of considerable interest for those firms that are considering applying the volatility adjustment to their with-profits books, or those firms with a large holding in inadmissible (for a matching adjustment) assets which made the volatility adjustment a credible alternative.

The newly published technical specifications also provide more clarity on how the volatility adjustment should actually be applied – as expected, it will result in a parallel upwards shift to the risk-free curve. However, the technical specifications have clarified that the volatility adjustment will not apply beyond the last liquid point – this is unlikely to be a significant concern to insurers as the curve will ultimately converge to the (generous) ultimate forward rate beyond this point anyway.

Some firms will be left disappointed that the new technical specifications confirmed that the volatility adjustment should remain unchanged within a spread widening stress. While this was generally expected by the industry, some had remained hopeful that an argument could be constructed for some spread widening allowance within the volatility adjustment. It remains unclear whether internal model firms may feel they could still justify such an argument.

Transitional measures around discount rate and technical provisions

The transitional measures were already well defined within Omnibus II, and most uncertainty was directed at how the measures would be interpreted by national regulators. This uncertainty remains, although in recent months, the PRA in the UK has indicated that it will consider the use of a "double lock" type approach based on the more onerous parts of Solvency I and ICA.

The new technical specifications have clarified how exactly the discount rate transitional should be calculated. The formulae prescribed are in line with what most insurers would have expected (and will result in a parallel upwards shift in the yield curve across all durations).

It is also clear that the transitional measures should not be recalculated within the SCR calculation – these should remain the same before and after the stress is applied. It is not clear whether this is intended as a simplification for interim reporting, or whether it is representative of EIOPA's view on this issue.

Credit risk adjustment applied to the risk free curve

Under Solvency II, a deduction will be applied to the swap curve to allow for residual credit risk. Insurers have been concerned that this credit risk adjustment could potentially be volatile. Within recent months, there has been considerable industry lobbying regarding the calculation of this adjustment, with suggestions that it should remain stable and be subject to a cap.

The technical specifications show that the industry has been partially successful in lobbying on this point – the credit risk adjustment is subject to a cap of 35bps as well as a floor of 10bps.

However, the industry will be disappointed that the credit risk deduction will remain volatile between this cap and floor; it will be determined based on market data and hence subject to market volatility. This will make it difficult to hedge liabilities and will introduce a volatile element to even a very well cash flow matched balance sheet.

What do firms need to do now?

The newly released technical specifications are very detailed, at over 400 pages. Properly assessing the implications of these requires a significant effort. In Denmark, firms face a double challenge having to comply with updated solvency requirements (“Ensartet beskyttelse af forsikringstagerne”) as well as making sure that their existing models and methodologies remain in compliance with the latest regulations. The technical specifications have also provided firms with greater clarity on some aspects of the long-term guarantee package. Firms will need to consider the new requirements and ensure that their selected approach remains optimal for their business.

A number of key areas within the long-term guarantee package remain uncertain, most notably the treatment of assets which are potentially inadmissible for a matching adjustment, such as callable bonds and mortgages assets, as well as the extent of cash flow matching which will be required. Many firms have already begun to consider work-around solutions to ensure that they continue to benefit from the yield uplift while complying with the regulations. In order to properly assess the impact of these regulations, firms will have to develop a “house view” on the remaining key areas of uncertainty, as well as engaging with the regulator as early as possible.

Given the complexity of regulation and the significant impact that an inappropriate judgement could have on the solvency positions, many firms considers getting external support and assurance, particularly in validating that the key judgements applied are appropriate and in line with emerging industry best practice.

Many large and medium-sized firms will also be asked by the regulator to participate in the stress testing exercise. These firms will have 10 weeks to calculate their Solvency II balance sheets under a range of market and insurance risk stresses – the largest firms may have to prepare several submissions, both on a group and individual entity basis. Given the significance of this stress testing exercise and the potential consequences of getting it wrong, many firms will be considering the need for validation of their results prior to submission to the regulator.

Contact

We can help you complete your stress testing submissions as well as providing external assurance and support around the process and key areas of judgement.

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