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Financial Institutions
Internal Market Directorate-General
European Commission

CC: Gabriel Bernardino (EIOPA)

6 June 2014

Joint Insurance Europe, CFO and CRO Forum letter on Solvency II - Volatility Adjustment

Dear Klaus,

As highlighted in the recent PEIF, CFO Forum, CRO Forum's and Insurance Europe's position papers on remaining issues in the Solvency II level 2 regulation draft[1], it is of paramount importance for the industry to ensure that the political agreement reached in Omnibus II is reflected in the detail of regulations within the delegated acts and that the most significant issues are addressed before the launch of Solvency II.

The Volatility Adjustment (VA) design and calibration methodology (including calculation of the reference spread) and the Credit Risk Adjustment (CRA) are one of the industry key priorities. The VA should act as a counter-cyclical tool. It is fundamental to shelter insurance undertakings against undue short-term market volatility and to prevent incentivizing pro-cyclical investment behavior. Moreover, the CRA is de facto subtracted from the swap rates in order to calculate the risk-free rate and thereby would undermine the effect of the VA and reduce the intended goal of tailoring the regulation for undertakings with small exposure to overall financial volatility[2].

Since the issuance of the last version of the Delegated Acts in March, EIOPA published technical specifications with regards to the 2014 stress test exercise, including the level of both the VA and the CRA (10 basis points for the Euro) as at end of 2013.

We appreciated recent workshops with EIOPA in order to discuss the technical specifications and the stress test. However, no detailed documentation has been provided so far in order to explain the calibration of those important adjustments. **It is essential that the methodology used to derive both the currency Volatility Adjustment and the country specific component (including non EEA countries) is transparent and clear. In addition, these adjustments must be predictable, replicable and available in advance to allow insurance companies to determine ex-ante the market conditions in which the VA could be activated and adequately incorporate it in their risk management processes and systems**.

It will also be essential for EIOPA to begin publishing Solvency II yield curves with and without volatility adjustment on at least a quarterly basis in a timely manner at latest by year end 2014. These curves must be issued on the "first working day" after the related period end, since any later would impinge significantly on the time available for regulatory reports.

According to technical specifications as of 30th April, the volatility adjustment for the Euro would amount to 22 basis points at end of 2013. This amount would be around 15 basis points (bps) lower than industry estimations based on the latest draft for Delegated Acts using transparent market

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[1] Please refer to the document *Solvency II – Remaining issues* dated 12th February 2014 issued by the PEIF, CFO Forum and CRO Forum and to ECO-14-042 Final Insurance Europe letter on Solvency II Delegated Acts sent by Insurance Europe to the EC on 6th March 2014.

[2] We would like to reiterate that the corridor with a floor at 10 bps would be disproportionate considering that 60% of the time since 2000 the adjustment would have been around 5 bps, and a cap at 35 bps would still leave unmanageable volatility in the risk-free curve when there is a market disruption.

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indices[3] without possibly understanding the discrepancy. Additionally, against our expectations, national adjustments in a period of time where Sovereign debt is still under stress were only to be applied in Italy and Greece and even in those cases, to a very limited degree.

We acknowledge that the methodology is still in its early stage and the reference portfolio definition will be revised prior to the entry into force of Solvency II. However, it should be highlighted that, **based on estimations derived from the data of EIOPA LTGA report, undervaluing the volatility adjustment by 10 bps could have an impact of at least 12 billion Euro on surplus capital resources[4] at the European level**. Moreover, we understood that EIOPA was planning to derive its own index based on industry data collection exercises, and the calibration of VA at end of 2013 – for stress testing purposes – has been based on the FY2011 Long Term Guarantees Assessment (LTGA) asset allocation data.

Such a process will undermine the agreement reached in the Level 1 Directive. Omnibus II agreement indeed clearly states in recital 17g) that *The spread on the reference portfolio referred to in paragraph 2 of Article 77d [Volatility Adjustment] should be determined* ***in a transparent manner using relevant indices where available***. This has been re-emphasized in the draft Delegated Acts as follows:

> *[Article 41 sub 2]*
> *For each currency and each country, the reference portfolio of assets shall meet the following requirements: [...]*
> *(b)* ***where available the portfolio is based on relevant indices****;*
> *(c) the* ***indices*** *referred to in point (b)* ***are readily available to the public and published criteria exist for when and how the constituents of those indices will be changed****;*

In addition to the underestimation of the VA level, uncertainty with regards to the methodology and unpredictability would introduce undue volatility which would be impracticable for insurers.

For those reasons and in order to ensure that the Volatility Adjustment remains an effective measure for long term insurance business and meets its objective of being a counter-cyclical tool, as intended by Omnibus II, we believe the **methodology to derive the reference portfolio by currency and country should be determined in transparent, predictable and replicable manner.** Moreover, the same principles of transparency should be applied to the Credit Risk Adjustment.

The industry remains engaged in order to propose suitable solutions. We are ready to offer our assistance to cooperate with the European Commission and EIOPA to develop such methodologies given the capabilities and expertise we have within our industry.

Yours sincerely,

Olav Jones Insurance Europe	Gerald Harlin CFO Forum	Marco Vet CRO Forum

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[3] Calculations based on the latest draft of the Delegated Acts using LTGA asset allocation for govies and corporate, FY2013 market indices quotations for reference spreads (Iboxx, ECB 10y), and 35% (resp.30%) of long-term average spreads on those indices for corporate (resp. govies) to reflect fundamental spreads.
[4] Estimation based on CCP sensitivities as reported by EIOPA in the LTGA report - table 5 - page 48. This figure is based on a sub-sample (ca. 80%) of the LTGA participants representing an EU market coverage of 59% for life business and 25% for non-life.

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