Insurance Lab Center PwC

Point of view:
Agreement reached on long term guarantee package

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The initiative Insurance Lab PwC

PwC Insurance Lab is an initiative dedicated to insurance Companies which envisages a structured set of activities, aimed at:

- understanding the effective needs thanks to structured monthly **roundtable-based** meetings;
- analyzing, within PwC Insurance Lab **Research Department**, the latest regulatory developments and innovation matters, and investing in methodologies development, tools and operating models for risk assessment and measurement as well. The Research Department represents the source of innovative initiatives that will then be proposed by the **Lab Center**; and periodically launch "**Point of View**" on the evolution of local and International regulation and on innovation;
- proposing new project activities, within the **Lab Center**, with the aim of knowledge and cost sharing and a partnership approach with insurance Companies;
- stimulating debate with insurance Companies' senior management, thank to the **Thought Leadership & Lunch** event;
- providing structured comparative analysis of business trends or functions through **Benchmarks** analysis.

Round Tables

Debates and workshops during which PwC will share its own international experience, methodologies and the deliverables useful for participants' Business As Usual activities.

The debates will also deal with regulations still under consultation phase in order to help the undertakings in their assessment

Lab Center

«Pool» project activities involving both the insurance Companies, Universities and PwC's subject matter experts, throught a knowledge and cost sharing approach

Topic 2014: Compliance Risk

Benchmark

Provide awareness to participants on international best practices

Research Department

Deep analysis of new subjects under developments and provide to participants effective results. **Point of View** and **Innovative Projects** will represent the final output to be proposed to the market through the **Lab Center.**

Thought Leadership & Lunch

Debate among PwC's global network subject matter experts and insurance Companies' CEOs on market trends

Topic 2014:Multichannels and Digital world

Summary

On Wednesday 13 November 2013 the Trilogue (the European Parliament, the Commission and the Council) reached agreement on the Long-Term Guarantee ('LTG') package, defining the way long-term products will be valued under Solvency II.

This has been one of the most heavily debated issues within Solvency II, and agreement means the last major hurdle in its development has been overcome. It is expected that Omnibus II will be approved by the European Parliament in February 2013 - making a Solvency II 'go-live' date of 1 January 2016 increasingly certain.

There was a lot at stake - during 2012, after several rounds of discussions, the Trilogue failed to reach agreement on the LTG package and many considered the future of Solvency II to be under threat.

To resolve the deadlock EIOPA was commissioned to undertake an impact assessment (the 'Long-Term Guarantee Assessment') and its report was published in June 2013.
Details of the final package have not yet been released, however a tweet sent by Sharon Bowles MEP after the trilogue meeting suggests EIOPA's recommendations (**EIOPA publishes findings on LTGA**) look set to be implemented, albeit with a number of refinements to address industry concerns.

The LTG package is likely to be broadly welcomed by the insurance sector. Whilst some insurers will be left disappointed with points of detail, more generally the clarity which this agreement brings allows the industry to begin making the preparations necessary for Solvency II readiness.
The LTG package contains three main measures which will be of most interest to insurers:

The ***"matching adjustment"***, under which the discount rate will be based on the risk-adjusted yield earned on the assets backing liabilities. We expect that the matching adjustment will be available for annuities and PPO claim liabilities, but also that the final measure will be unlikely to address many concerns expressed by industry, particularly around the loss of diversification and a requirement for assets to have certain characteristics, such as fixed cash flows, in order to qualify.

The ***"volatility adjustment"*** is likely to be available for all business other than unit-linked contracts. It has been made more generous than EIOPA's original proposal and doesn't attract the regulatory and compliance issues associated with the matching adjustment, nor result in a loss of diversification benefit. As a result the volatility adjustment now appears a credible alternative for annuity writers, and will also be of interest to with-profits insurers.

Two ***"transitional measures"*** have been introduced, one in respect of the discount rate and the other a 'catch all' covering technical provisions.

These will allow insurers to gradually move from Solvency I to Solvency II for business in force at the date of implementation over a period of 16 years, subject to regulatory approval.
These could prove a benefit to insurers who value guarantees using a gilt curve, as well as those who wish to gradually introduce the risk margin.
However the use of transitionals is also likely to cause significant operational challenges.

The optimal methodology choice is not obvious and will vary between insurers. As a result firms should perform an impact assessment to understand the strategic implications of each option under a range of economic conditions.

Alessandro Di Lorenzo
Solvency II Leader

Background

On 13 November 2013 the Trilogue reached agreement on the package of measures to be used in the valuation of long-term business ("the LTG package"') under Solvency II. This agreement is a significant milestone in the development of Solvency II - the choice of discount rate was the "last great unknown".

What are the key outcomes for the industry?

Whilst the final LTG package has not yet been publically released, its most significant elements have been widely reported in the media.
The information below is based on publically available information. As a result **details of the final package could differ**, although these instances are expected to be minor.
Many of the measures within the LTG package (such as extrapolation of the yield curve) will be the responsibility of EIOPA to implement. For these, there is very little insurers need to do other than understand the consequential impact on their capital positions.

However the LTG package does provide insurers with optionality in three crucial areas:

- *Applying a matching adjustment*
- *Applying a volatility adjustment*
- *Applying transitional measures*

This optionality gives insurers an opportunity to optimise their Solvency II balance sheets, potentially worth billions to reported solvency positions within the insurance sector, albeit at a loss of consistency between firms.

Matching adjustment

The "matching adjustment" will link the discount rate for annuity and PPO claim liabilities to the yield earned on the assigned assets backing those liabilities, less a deduction for credit risk (termed the 'fundamental spread'). The fundamental spread will be provided by EIOPA on a quarterly basis for each asset type and credit rating. There will be a prudent "floor" to the fundamental spread so that it will always be at least 35% of the long-term average spread (30% for government debt).

Within the LTGA report EIOPA suggested a number of strict qualifying criteria for the matching adjustment. Whilst details are yet to be publically confirmed, there has been no suggestion within recent media coverage that any of these requirements have been relieved within the final LTG package:

- *It will **only be available for valuing annuities** (and some deferred annuities) and non-life PPO claim liabilities;*
- *It requires insurers to achieve **cash flow matching** between assets and liabilities;*
- *It is expected that the asset portfolio must have **fixed cash flows** - this might preclude commercial mortgages, equity release mortgages or callable bonds without some form of restructuring;*
- *That said, we expect assets whose **cash flows vary with an index** (such as inflation) will be allowed, provided these are held to match liabilities linked to the same index;*
- *For capital calculations we expect that **no diversification benefit** can be assumed between matching adjustment liabilities and the wider book of business;*
- *The asset portfolio **cannot be amended** other than to maintain cash flow matching;*
- *We expect restrictions on holding **sub-investment grade assets to be relaxed**, albeit with a cap on the extent of spread pick-up from these assets.*

Volatility adjustment

The "volatility adjustment" is a constant addition to the risk-free curve. It will be provided by EIOPA on a quarterly basis for each currency (with a country specific overlay to provide further relief when spreads in a particular country are very wide, i.e. those countries whose spreads are outliers to the currency block).

The volatility adjustment will be determined using a formula, and will be based on 65% of the risk-adjusted yield earned from a "notional portfolio". The notional portfolio will be defined by EIOPA and will represent the typical asset portfolio held by insurers within each currency/country. It remains unclear how frequently the mix of assets within the notional portfolio will be updated.

Again, whilst the details are yet to be publically confirmed, there is no indication that any of the qualifying requirements will be amended from those suggested in EIOPA's LTGA report.

As a result the requirements for the volatility adjustment are likely to be much less restrictive than the matching adjustment, in particular:

- *We expect that use of a volatility adjustment will* ***not require approval from the regulator;***
- *It should be available for* ***all contracts*** *other than unit-linked business and those contracts to which a matching adjustment is being applied;*
- *We expect there to be* ***no restrictions on asset admissibility****, or a requirement for fixed asset cash flows;*
- *We expect* ***no loss of diversification*** *credit within the SCR calculation;*
- *We expect no requirement* ***to cash flow match.***

However using the volatility adjustment will introduce a mismatch between the value of assets and value of liabilities, as the link, which exists under Solvency I, between the discount rate and the yield earned from the asset portfolio will be broken. The extent of this mismatch risk will depend on how the notional portfolio compares to the assets which are actually held by insurers.

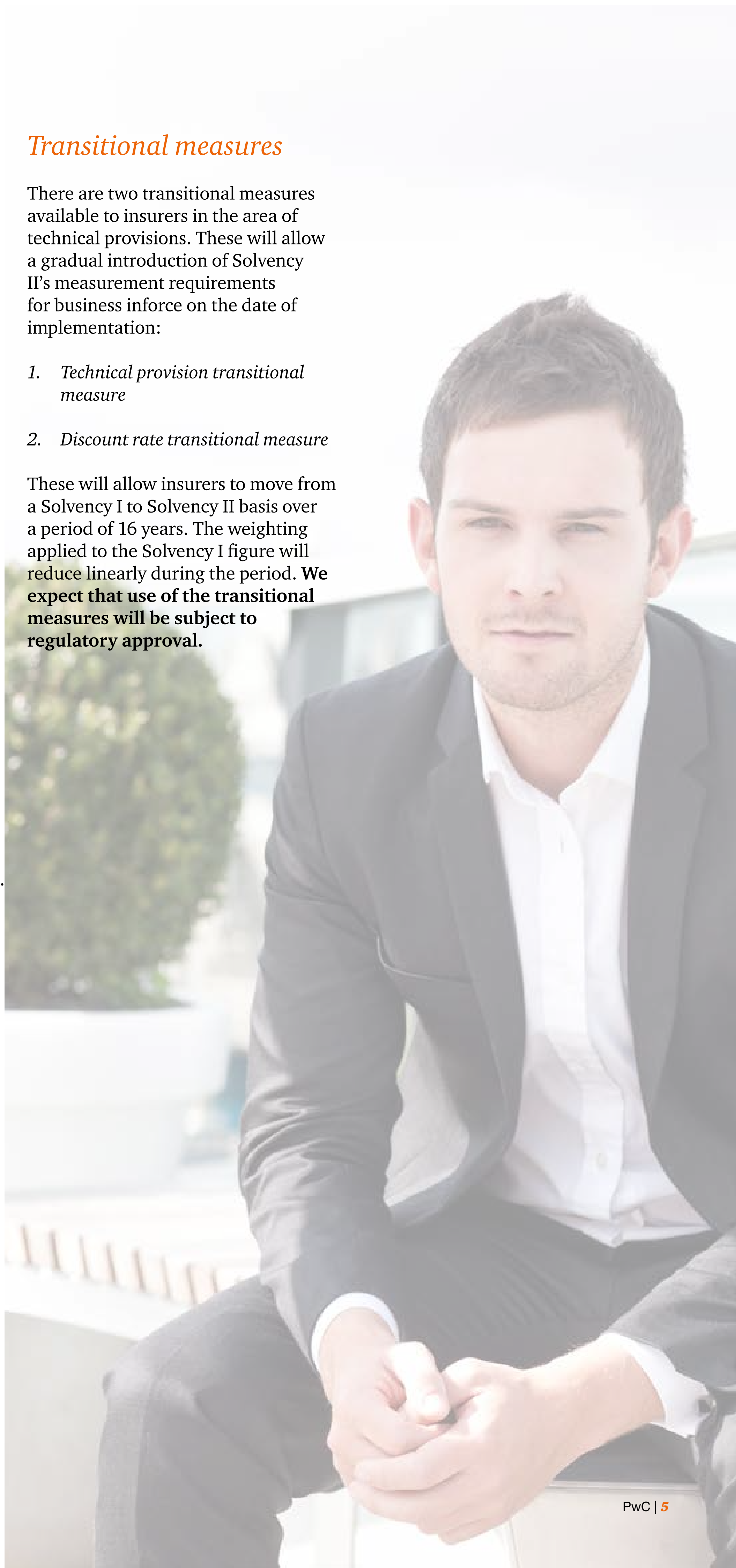
We also expect that the volatility adjustment will not widen under a credit spread stress, making technical provisions less loss absorbent and somewhat reducing the effectiveness of this measure.

Transitional measures

There are two transitional measures available to insurers in the area of technical provisions. These will allow a gradual introduction of Solvency II's measurement requirements for business inforce on the date of implementation:

1. *Technical provision transitional measure*
2. *Discount rate transitional measure*

These will allow insurers to move from a Solvency I to Solvency II basis over a period of 16 years. The weighting applied to the Solvency I figure will reduce linearly during the period. **We expect that use of the transitional measures will be subject to regulatory approval.**



What are the key implications of the LTG package?

As explained above the LTG package will offer insurers three methodology options under Solvency II. Understanding the strategic implications of each of these options is crucial - making a wrong decision now could be challenging and costly to reverse in the future.

There are six key questions which insurers should consider now in order to optimise their businesses for the LTG package:

1. Would I be better to apply for a matching adjustment or use the volatility adjustment?

For annuities or PPO claim liabilities insurers will have a choice of adopting either the matching adjustment or the volatility adjustment. Although the matching adjustment is likely to give a higher discount rate than the volatility adjustment, it's wrong to consider this in isolation - we expect the matching adjustment to attract a number of additional regulatory and compliance requirements, as well as a loss of diversification benefit. When all these factors are considered in aggregate the volatility adjustment appears a credible alternative.

For most insurers, particularly those which achieve significant diversification credit between their annuities/PPOs and the rest of their book, the optimal methodology choice is far from clear.

Given this, an impact assessment will be necessary to model technical provisions and the SCR for each option under both base and extreme market conditions. This assessment should identify the optimal option by considering the impact of each on the balance sheet, capital requirements, income statement and the extent of volatility which is introduced. This assessment should also highlight whether the option remains optimal under market stresses.

It will be particularly important to assess the extent of mismatch risk introduced by the volatility adjustment, and also consider how sensitive this mismatch might be to future changes in the notional portfolio. Indeed changes in the notional portfolio may actually benefit some insurers, particularly if the insurance sector makes a shift into higher yielding illiquid assets whereas the insurer is running a lower risk investment strategy.

The impact assessment should also reflect the likely costs of transitioning or restructuring asset portfolios, as well as the possible tax implications.

2. What do the transitional measures mean and how should I apply them?

Provided approval is given by the PRA we expect that the technical provisions transitional will allow the risk margin to be deferred and introduced over time, albeit this benefit will be partly offset by extent of prudence built into Solvency I liabilities.

We also expect that the discount rate transitional measure will allow with-profits insurers to gradually move from valuation on a gilts plus 10bps basis to swaps less 35bps basis (as suggested by EIOPA for the LTGA), and for annuity writers to phase in the Solvency II discount rate.

Whilst these transitionals will be beneficial to insurers, an impact assessment will be necessary to understand how they will affect the balance sheet under market stress as the asset/liability mismatches introduced could become onerous. These could also make it difficult for insurers to run their businesses using a Solvency II metric, as the balance sheet will not necessarily move in line with this.

Using transitional measures may also force Solvency I reporting processes to remain "online". Insurers will have to consider whether both reporting bases can be integrated, and the consequential impact of this on reporting timescales.

Whilst the extent of public disclosure requirement remains uncertain, we expect that analysts and shareholders will seek to measure performance of individual insurers using a comparable basis, which will exclude the effect of transitional measures. This may effectively force full public disclosure and require additional communications to explain the resulting change in capital position without transitionals.

3. How should I allow for the LTG package within my internal model?

Many insurers have designed their internal models to assume an illiquidity premium which behaves in a simple manner under stress; for example some insurers use the simplistic approach of assuming 50% of the credit spread widening stress can be reflected within the discount rate.

Whilst this simplification may be appropriate for some firms, a more scientific approach is likely to be necessary where this is a material assumption. In particular it may be necessary to recalculate the fundamental spreads under each credit spread stress, with appropriate allowance made for the long-term floor "biting" in some scenarios.

The extent of any cash flow mismatch introduced by a demographic stress and the consequential impact this would have on the availability of a matching adjustment should also be considered. This will also introduce complexity when fitting loss functions, as liability values will no longer move linearly under stress.

4. *What changes do I need to make to my systems and processes to produce the MI required?*

We expect that there will be a number of regulatory and compliance requirements associated with the LTG measures. These could include calculating and publically disclosing the effect of removing the package, and regular monitoring to ensure cash flow matching is maintained.

Each of these requirements will place an additional burden on systems and processes which are already struggling to meet Solvency II's challenging reporting timescales.
As a result firms will likely have to enhance existing systems and reporting processes to ensure that the additional compliance burden can be met.

5. *What should I do with the non-standard assets which I currently use to back my annuities?*

EIOPA's LTGA report suggested firms who wished to adopt a matching adjustment would not be permitted to hold assets with variable cash flows within their matching portfolio. There has been no suggestion within recent media coverage that this requirement has been relaxed.

This will mean non-standard asset types such as commercial mortgages, equity release mortgages and callable bonds may well be excluded in their current form owing to pre-payment risk.

This is an issue for many firms who have significant holdings in non-standard assets. One option would be to use the discount rate transitional measure, which should have sufficiently long duration to allow these assets to naturally run-off the balance sheet.

However this strategy would introduce the difficulties outlined in respect of transtionals and would also require PRA approval. Another option would be to sell these assets and transition into admissible corporate bonds, however given the size of some mortgage books and the lack of liquidity in the market this is unlikely to be easily achievable without accepting a significant haircut to asset value. If it is possible to sell these assets, a key consideration will be identifying the most appropriate time to perform any transaction.

It will also be necessary to consider how future investment strategy is impacted, as transitional measures will not be available to provide relief for business written post-Solvency II implementation. If the fixed cash flows requirement applied at a portfolio level rather than an individual asset level firms could restructure non-standard assets to make them admissible, or to obtain a swap overlay which cedes the prepayment risk to a third party.

Restructuring is likely to be the most cost effective option, although the legal and practical steps in doing so are not simple.

6. *How do I ensure I am maximising the risk-adjusted return I achieve from my asset portfolio?*

Most insurers have traditionally adopted a buy-and-hold annuity investment strategy. In recent years financial markets have undergone a significant period of disruption and as a result many asset portfolios are underperforming due to increased volatility.

EIOPA's LTGA report suggested that the firms with a matching adjustment could only rebalance their asset portfolios to maintain cash flow matching and there has been no suggestion that this has been relaxed.

As a result insurers might find it difficult to optimise an underperforming portfolio in the future, or for an open portfolio can only do so gradually as new business is written - and so should do so before Solvency II is implemented. Even for high performing portfolios there is a strategic opportunity to rebalance and target investment in sectors which minimise EIOPA's fundamental spread deduction.

Using a relative value driven approach will be key to identifying the asset portfolio which maximises the risk-adjusted yield whilst minimising capital requirements. The complex interaction between yield and capital should be reflected within this process, particularly if insurers choose to adopt transitional measures which will require optimisation on both a Solvency I and Solvency II basis.

What should I do now?

The LTG package will provide insurers with optionality around the methodology which is adopted under Solvency II. Determining the optimal methodology choice will not be a simple exercise.

It is important that firms undertake an impact assessment now to understand each of the options available and assess how these impact the balance sheet, capital requirements, income statement, as well as understand the extent of volatility which is introduced under each measure. This impact assessment will be required under both base and stressed economic conditions.

Following this impact assessment firms should consider the implications of the LTG package in four main areas:

1. *The wider strategic implications of the package - such as how to price annuities and the types of contracts which will be written in the future*

2. *The regulatory implications of the package - such as the steps involved in obtaining PRA approval for the chosen approach and ensuring it is appropriately reflected within the internal models*

3. *The investment strategy implications - such as restructuring or transitioning inadmissible assets and taking a longer term view around the types of assets which will be held to back liabilities in the future*

4. *The practical implications of the package - such as enhancing existing models, speeding up existing reporting processes and producing the management information required for the ongoing monitoring*

Our team is working with a number of firms in these areas and would be delighted to discuss any of these issues further.

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