insurance europe

Position Paper

Response to EIOPA consultation on the proposal for IBOR transitions

Our reference:	ECO-SLV-21-207	Date:	26 July 2021
Referring to:	https://www.eiopa.europa.eu/content/consultation-proposal-ibor-transitions_en		
Contact person:	Prudential team	E-mail:	prudential@insuranceeurope.eu
Pages:	5	Transparency Register ID no.:	33213703459-54

Questions

Chapter II

Q1. *Do you agree with the overall approach of the immediate switch subject to the two preconditions?*

Yes

Insurance Europe considers that the proposed immediate switch from IBOR-based to OIS-based term structures is a major improvement to the previously proposed blending approach.

However, to ensure that the switch results in a smooth transition for the industry, Insurance Europe highlights a number of key issues relating to the switch that require further consideration prior to implementation of the proposed approach.

1. **Mitigating the impact** EIOPA should ensure full transparency about the potential impact of the IBOR transition. The aggregate results of its information request on the impact of the IBOR transitions should be made public to ensure that the impact can be appropriately taken into account in the 2020 review of Solvency II.
2. **Mitigating the solvency volatility** Insurance Europe is concerned that the preconditions proposed by EIOPA could result in temporary changes to the LLP or the underlying instrument (ie, swaps or government bonds) which would create solvency volatility as well as other operation and risk management challenges. Appropriate flexibility should be foreseen to avoid unnecessary solvency volatility by ensuring the stability of LLPs and the choice of instrument after the switch occurs.
3. **Regular communication** The development of market liquidity will be the primary driver of the timing of the switch. Regular communication from EIOPA on the DLT of all the RFR markets would help to prepare the industry for any change and would likely support a speedier adoption of new OIS-based curves. It would be helpful if EIOPA could produce a dashboard of liquidity indicators for the OIS swap markets, along with expected timelines (ie, target switch date/IBOR cessation dates). Also, disclosure of the exact quantities (eg, Refinitv/Bloomberg tickers incl. "value type") that are being monitored would be helpful.

Prudential team
Insurance Europe aisbl • rue Champ de Mars,23 B-1050 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail: prudential@insuranceeurope.eu
www.insuranceeurope.eu

4. **Time for implementation** EIOPA must provide sufficient time to implement the switch. Confirmation that a switch will be made should be no later than in the first month of a (new) quarter (ie, a minimum of two to three months' notice).

***Q2.** Do you agree with the way the 'liquidity' condition is defined?*

No

Insurance Europe is concerned that the liquidity precondition could result in changes to the LLP or to the choice of instrument that would only be of a temporary nature and that could therefore result in significant solvency volatility across the industry, as well as creating operational and risk management challenges for the industry.

To avoid undue volatility in the LLP or temporary changes of instrument, the liquidity precondition should be refined to adequately address these potential issues. For example, EIOPA could alter the criterion so that instead of considering overall trade volume, it concentrates on those maturities that are most important for the valuation of the technical provisions of European insurers.

It would also be helpful if EIOPA could clarify how it will assess the liquidity condition in conjunction with changes to the LLP (in particular for the Euro where a 20-year LLP is foreseen in recital 30 of the Omnibus II Directive).

While a 50% threshold on the traded volume of OIS swaps appears to be a sensible precondition if an immediate switch is to be carried out, it is not clear how the precondition could impact the LLP and/or the choice of instrument on a temporary or permanent basis.

Traded volume is typically higher at shorter maturities. This could mean that the 50% threshold is reached but with a different LLP (eg, as is currently expected to be the case for GBP). Therefore, this approach might ignore the importance of having liquidity across the curve, and notably the longer end.

However, it seems reasonable to assume that the market liquidity of OIS-based swaps will quickly increase as the final cessation date of IBOR-based swaps approaches, if one is agreed (eg for GBP-LIBOR and SONIA).

Finally, it is worth highlighting that the liquidity of the OIS markets will not only impact the LLP/choice of instrument but could also constrain the ability of insurers to hedge their long-term exposures.

***Q3.** Do you agree with the way the 'proximity' condition is defined?*

No

While it is desirable that the deviation between the OIS-IBOR curves is minimal when the transition is carried out, it is not clear that the proximity precondition would achieve its objective of mitigating against a potentially significant balance-sheet impact.

- Monthly changes in the RFR curve will affect both liability valuation and the value of the hedging assets. Switching to OIS-based swaps will only affect the value of the liabilities. Therefore, even if the deviation of the IBOR vs OIS curves is of a similar level to the average monthly changes, it will have a greater balance-sheet impact than the monthly changes.
- As noted in response to Q2, experience to date suggests that the liquidity of the OIS swap market will increase at the shortest tenors first, which suggests that EIOPA's liquidity precondition could therefore result in a (temporary) change in the LLP (as is currently the case for GBP, USD and CHF).

Insurance Europe considers the proximity criterion to be a very important to ensure a smooth transition and to ensure that there are no direct negative effects from the switch. In order to guarantee this, it proposes to add the additional condition that the absolute difference between the two curves should not exceed a certain level (for example, somewhere between 2 and 5 basis points).

Moreover, there appears to be no back-up plan should the proximity condition fall outside its boundary again. Any adverse balance-sheet impact may be better addressed via transitional measures to smooth such undesired impacts over time.

In addition, some important details are still unclear:

- Is it the difference between EURIBOR swap rates and OIS swap rates that is being compared (not taking into account the CRA), or is the CRA subtracted from the EURIBOR swap rates first?
- How is the "difference of the two curves" being calculated? As the average of the differences for each tenor from 1 to 50 years?
- What is meant by "observed monthly volatility of rates"? Is it measured as the standard deviation of monthly return? And if so, over which period of time?
- For which maturities does the proximity condition need to be fulfilled? It is not clear how the proximity precondition is applied when there is a change in the LLP. Any change in the LLP could have a significant impact on the value of liabilities.

Q4. *Do you believe the 'proximity' condition has to be met for the three consecutive months or a shorter period would be sufficient?*

No

The proximity precondition should ideally be satisfied for a minimum of three consecutive months (and potentially even longer). However, it is recognised that this may not be achievable if liquidity in the OIS market does not increase until near the cessation of the IBOR rates.

Please also see response to Q5 on the need for sufficient implementation time.

Q5. *Do you think there is another condition EIOPA would need to consider for the immediate switch to the new OIS term structures?*

Yes

If/when the switch happens, insurers need sufficient time to implement it. The actual confirmation that a switch will be made should be no later than in the first month of a (new) quarter (so a minimum of two to three months' notice). The switch should also not be made at the end of the quarter to allow insurers time to embed any process changes before quarterly reporting.

If a local regulator (third country or other) switches for local supervision purposes, this may lead to volatility in the IBOR rates which could result in the proximity condition never being met, while the new OIS rates are essentially the standard rate.

In light of the above, EIOPA could also consider dropping the proximity precondition if a higher amount of market liquidity is achieved, such as 80% of the traded volume across the majority of currently liquid tenors.

Impact on 2020 review of Solvency II

Should the IBOR transition result in a change in LLP, this could have a secondary impact on EIOPA's proposed changes to the extrapolation methodology.

If the alternative extrapolation methodology does replace the Smith-Wilson methodology, EIOPA should explain how the IBOR transition will impact the RFR curves under the new methodology.

Q6. *Do you believe that the foreseen changes in the RFR methodology due to IBOR transitions and the method of switching the underlying instruments (depending on the proximity and liquidity condition) could have an impact on the market rates itself, and if so, with what impact and how might this be mitigated?*

Yes

Higher liquidity should be expected as soon as the switch has taken place, as demand for hedging instruments will increase, particularly at the long end of the curve.

Chapter III

Q7. *Do you agree with the overall approach regarding the CRA?*

Yes

Insurance Europe agrees that there should be no CRA for OIS swaps.

However, it does not agree that the CRA should be applied to RFR curves where the underlying instrument is government bonds.

Article 45 of the Delegated Regulation, which sets out the calculation methodology for the CRA, solely refers to swap rates. Adjusting government bond rates to account for the difference between OIS swap rates and IBOR rates would result in artificially lower curves and makes no economic sense.

Q8. *Is there any alternative option you believe EIOPA would need to consider regarding the treatment of the CRA?*

Yes

Insurance Europe agrees with EIOPA's assessment that Article 45 of the Delegated Regulation which clarifies the application of the CRA implies that the floating rate is supposed to be a term (ie non- overnight) swap rate, meaning that after the transition to OIS rates, this condition is no longer fulfilled and thus it is legally possible not to apply the CRA to OIS-based term structures.

However, it would provide additional certainty if the European Commission made a public statement that it agrees with this interpretation of the Delegated Regulation.

Q9. *Would you have a view on how to treat the CRA for those currencies for which the CRA is currently being derived from either the CRA for the EUR or the CRA for the USD?*

Insurance Europe does not currently have any conclusive views but suggests that ISDA fallback rates could potentially be used to supplement the calculations of CRAs, which are reliant on Euro data.

Another possibility could be to derive the CRA from the rating of the country.

Chapter IV

Q10. *What is your opinion about the proposed changes in the LLPs and the use of government bonds for the JPY and CHF?*

As noted in response to Q2, Insurance Europe does not support an approach that would create undue volatility arising from temporary changes in the LLP or the choice of underlying instrument.

Where there is a reasonable level of existing liquidity and clear evidence of increasing liquidity in the OIS market, it may be preferable under a temporary, forward-looking assessment of liquidity to stabilise the LLP and to adopt OIS-based term structures rather than change to government bond rates.

Regarding the changes outlined in the consultation paper, Insurance Europe notes that the changes outlined in the paper could change over the coming months as OIS swap liquidity is expected to increase as IBOR swaps are phased out. Observations on each of the specific currencies mentioned are outlined below.

GBP — The PRA's adoption of SONIA-based term structures with an LLP of 50 years from 31 July could drive liquidity of the longer end of the GBP curve.

USD — A 30-year LLP is reasonable. This is consistent with EIOPA's assessment of the LLP for the IBOR-USD produced for its Opinion on the 2020 review of Solvency II.

CHF — The ISDA-Clarus RFR Adoption Indicator for CHF shows a significant increase in derivatives trading activity conducted in OIS risk-free rates, being at the moment significantly more liquid (currently over 15%) than other economies. Also, as CHF LIBOR will cease to be produced from YE2021, it is reasonable to expect trading volumes of OIS swaps to increase in the subsequent months (as seen in April 2021 and May 2021). Adopting SARON-based RFR curves could therefore be preferable to switching to CHF government bond curves.

JPY — Similarly, a temporary move to government rates should be avoided, since this could lead to huge unnecessarily volatility in the solvency ratio of the entities concerned.

Q11. *What is your view on the proposed treatment of the LTAS?*

This approach is reasonable given that a historic proxy for the new curve is not a trivial exercise. However, it would be helpful for recalculations if historical values were published by EIOPA.