

## Response to EIOPA discussion paper on impact of IBOR transitions on Solvency II risk-free rates

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### General comment

Insurance Europe strongly welcomes EIOPA's work on IBOR transition, which represents a significant opportunity to better enable the insurance industry to move away from IBOR-based swaps in the markets where this is motivated by a move to alternative reference rates.

**Where the transition is already in progress, there is an urgent need for clarity of how EIOPA's risk-free rates (RFR) will be transitioned.** At present, undertakings are unlikely to be willing to meaningfully transition their exposures to OIS-based instruments due to the inherent basis risk that would arise between their assets and the discount curves. This constitutes an obstacle to the transition that should be removed in order to enhance liquidity in new rates, particularly for longer tenors.

**However, more generally, Insurance Europe considers it too early to assess that a common approach to the transition across the EU is optimal.** As highlighted in the consultation, the approach and rate of change of the transition varies across markets. Notably, for the Euro market it is unclear if, when and how the transition to overnight indexed swaps (OIS) swaps will occur.

**EIOPA should also consider cross-border groups** headquartered in the EU that have the added challenge of managing multiple IBOR cessation deadlines. These firms may have more time to transition to alternative rates in their home market but less time in their host market. This underlines the urgency required to amend Solvency II beyond a limited number of European jurisdictions outside the Euro, since one market's timetable for transition will impact many large European firms at group level.

**In developing its approach, EIOPA should seek to maintain the level of liability valuations.** Current market indications are that the transition will lower the RFR curve which, all else being equal, would increase liability valuations. This consequence of the transition to OIS-rates raises a fundamental question about which risk-free rate is the most appropriate to be used in an insurance-business context.

In this context, Insurance Europe supports the removal of the 10-35 basis point CRA corridor for OIS-based swaps and considers that it may be appropriate to include an upwards adjustment to the OIS curve to reflect

the term lending rate that insurance companies can expect to earn risk-free. Further detail on the upward adjustment proposal is included in question 4.

**Insurance Europe considers that the impact of the transition to OIS-rates should be incorporated into “balanced package” that EIOPA seeks to achieve in the 2020 Review.** The question of the most appropriate RFRs to value insurance liabilities is also being discussed at length in the 2020 Review. In developing its proposals, EIOPA has recognised that (except for standard formula interest rate risk SCR), the current calibration of the framework does not provide inappropriate liability values and capital requirements.

EIOPA is encouraged to take the IBOR transition into account in these discussions, by investigating whether the Review offers opportunities for compensating any increases in liability valuations resulting from the IBOR transition.

**Regarding the options discussed to update the EIOPA RFR production, Insurance Europe does not agree with the proposal to implement option 2.** It has provided two alternative approaches which should be assessed fully prior to any decision being taken.

Furthermore, as noted above, it is unclear at present whether a common approach across the EU is optimal.

#### **Q1. Do you agree with the overall approach regarding the Credit Risk Adjustment?**

Insurance Europe agrees with and welcomes EIOPA’s statement that it would be paradoxical to apply the existing 10-35bps corridor to OIS-based swaps.

It notes the following additional considerations related to the credit risk adjustment (CRA):

- In the future, as some RFRs may be based on IBOR and others based on OIS swaps, the source and the size of the CRA should be clearly stated to ensure practitioners can clearly identify the source data.
- In light of the transition from EONIA to €STR, EIOPA should also clarify when and how it will implement the change from EONIA to €STR in the calculation of the CRA.
- As the current EUR IBOR RFR curve is constructed using 6M Euribor, it would make more sense to consider the 6M Euribor-OIS spread instead of the current 3M Euribor-OIS Spread.
- The 3M Euribor – OIS spread (a.k.a. 3M/OIS basis) has a term structure as well. Currently the CRA only looks at the 3-month term, but for life insurers a 10y term or higher might be more appropriate. The advantage would be that the 10y basis has 1/3 of the volatility of the 3M basis and therefore creates less volatility on the Own Funds. Secondly, given this lower volatility, the 12M averaging feature of the current approach would not be needed anymore, reducing complexity. Our proposal would be to replace the current CRA with the 10Y 3M/OIS basis.
- The use of applying moving averages, floors and ceilings can make the adjustment significantly different from what can be observed in the market.

#### **Q2. Do you consider OIS based swaps to have a non-negligible\* credit risk? If yes, what is your recommendation for calculating this risk? (\*Negligible is defined as below one basis point.)**

No, Insurance Europe considers OIS-based swaps to have negligible credit risk. These swaps are based on overnight deposit/lending rates and have negligible exposure to bank (or other) credit risk and provide the best proxy for risk-free rates.

However, as detailed further in our response to Q4 below, an unadjusted OIS curve does not reflect the term lending rate which insurers can expect to earn, and so an upward adjustment is required to make it appropriate for the insurance business model.

**Q3. Which is your preferred option for treatment of the credit risk adjustment?**

Of the options presented, Insurance Europe supports option 2. However, for OIS-based swaps an upward adjustment should be considered in order to derive an appropriate rate to discount insurance liabilities. This proposal is outlined in our response to Q4.

Additionally, Insurance Europe would welcome clarification from EIOPA that in the case of a blended curve, a positive CRA would only be applied to the IBOR rates prior to the blending.

Option 1 would result in the application of a positive CRA to OIS and therefore result in a market inconsistent RFR which would be inappropriate.

**Q4. Is there any alternative option you believe EIOPA would need to consider regarding the treatment of the CRA?**

In order to assess the most appropriate solution, consideration needs to be given to what the appropriate definition of the RFR is, in an insurance business context.

In this context, OIS reflects an overnight bank deposit rate and hence will reflect the typical bank business model of borrowing short and lending long. By comparison, the appropriate RFR for insurance undertakings should be based on the term lending rate that insurance companies can expect to earn risk-free, reflecting the insurance business model of investing premiums received over a predictable term without the funding risks inherent in the banking model.

This point is recognised in the current framework and is considered to be a key reason why the CRA is based on only 50% of the spread between IBOR and OIS rates (Article 45) alongside an intention to reduce volatility. For this reason, were OIS to be used as the basis of the Solvency II basic RFR, it would be necessary to apply an upward adjustment, for example 50% of the historical IBOR – OIS spread.

The switch from IBOR is a technical change to the framework meaning, all else being equal, this should not result in a material impact on insurers' liabilities. In selecting OIS, such as €STR and SONIA, EIOPA is not replacing IBOR rates on a like for like basis but choosing indexes with differing risk characteristics.

This means that, without further adjustments, any move from IBOR rates to OIS with a removal of the CRA but no upward adjustment would likely result in a material impact on insurers' liabilities. Based on data as at 31/12/19, this could lead to a risk-free rate circa 10 bps lower than previously, for both EUR and GBP, with corresponding increases in liability valuations:

31/12/19 (bps)	EUR (EURIBOR-€STR)	GBP (LIBOR-SONIA)
IBOR (10 year)	21 <sup>1</sup>	102 <sup>2</sup>
OIS (10 year)	-6	78
CRA	10	11
Net impact	-17	-13

1. 10-year swap rate where the floating references 6m Euribor
2. 10-year swap rate where the floating reference 6m GBP Libor

During the current COVID-19 related stress, insurers have seen these spreads increase further. Under EIOPA's proposals, OIS swap rates would be used directly with a zero CRA. Given the 50% calculation for the CRA described above, using OIS-based discount rates with a zero-CRA could lead to inappropriately high liability valuations and would be inconsistent with the current regulatory framework, which implicitly recognises that OIS swap rates need to be adjusted upwards to derive an appropriate risk-free curve for insurance liabilities.

**Q5. Do you agree with the overall approach regarding the blending of the new and old RFR term structure?**

Insurance Europe understands EIOPA's desire to develop a common approach to transition to the new rates and its desire for a methodology which reflects, rather than leads, market conditions. Furthermore, where regulators have set transition timetables there is clearly some urgency to develop an approach.

While noting the need for urgency, Insurance Europe nevertheless does not believe that a one-size fits all approach is appropriate. As noted by EIOPA in paragraph 4 and 5, the transition is a big challenge given the different approaches and rates of change in different jurisdictions.

The potential market impact in terms of liquidity and pricing of any approach to transitioning the EIOPA RFRs should also not be underestimated. In fact, it should be emphasised that, undertakings are unlikely to be able to meaningfully transition their exposures to OIS-based instruments when the EIOPA RFR curves reference IBOR rates, due to the inherent basis risk. This constitutes an obstacle to transition that should be removed in order to enhance liquidity in new rates. Insurers can be drivers of liquidity, especially at longer tenors.

A deeper analysis and understanding of the affected markets is needed. Their size, expected transition speed, speed of development of OIS- swaps and market participants are all idiosyncratic factors which could affect the transition approach.

It would also be helpful if EIOPA could publish data/results from its tool which monitors the depth and liquidity in the IBOR versus OIS market. This would assist the industry in better understanding the relative liquidity of the replacement rates on a semi-live basis.

Insurance Europe proposes two alternative approaches that should be considered by EIOPA which would be more appropriate than those which have been put forward. These have been outlined in the response to Q7.

**Regarding an overnight switch (option 1):**

- An overnight switch could lead to insurers' hedging costs dramatically increasing due to a single point in time mass transition, potentially resulting in banks pricing against the insurance industry.
- It may also provide a disincentive for market participants to adopt OIS-based swaps prior to the proposed transition date, due to basis risk. This has potential to reduce demand of OIS swaps and may impede the improvement of liquidity in the market prior to transition.

**Regarding a blended approach:**

- There is a risk that there will be significant problems and large costs with the implementation. EIOPA should be open to making improvements to its agreed transition process in light of experience and future market developments.
- Blended curves will be harder to hedge. Firms, along with regulators, will need to accept some level of basis risk without increasing capital requirements.
- EIOPA should publish both the blended and the OIS curve so there is market consensus / transparency on the final curves, once the transition is completed.
- The updated CRA must be applied to the OIS rates.
- The ratio, calculated under any blended approaches, should be based on DV01 volumes rather than notional volumes.
- An approach based on market liquidity has the potential to be volatile if there are large trades occurring when the measurement is made, which could be reversed in future months.

**Specific comments on option 2:**

- There is a strong market segmentation on the various parts of the term structure. OIS swap volumes take mainly place at the short end of the curve. Based on this approach, it will lead to a blend ratio also on the long end of the curve which cannot be (easily) absorbed by the market once insurance undertakings take action upon it.

- There should be an assessment of whether there is sufficient liquidity for the new RFR at the Last Liquid Point (LLP), across all relevant currencies, before the cessation of IBORs. The LLP may no longer be viable after LIBOR's cessation, due to the conceptual difference between IBOR and OIS RFRs which could drive a change in market dynamics and demand. Because longer swap terms are likely to be less liquid than shorter durations, it could be appropriate to reduce the LLP for a period of time during transition.
- The requirement for both the first and last liquid points of the curve to be deemed DLT prior to transition commencing may be challenging if there is a structural change in the market as a result of the benchmark rate switch – the LLP may reduce over the long-term and EIOPA should ensure that this should not become a barrier to commencing the transition.

#### Specific comments on option 3:

- EIOPA should investigate a very granular division of the curve when assessing liquidity. EIOPA should include a higher number of "buckets" for shorter durations (up to 20 years), on the yield curve, for example, when assessing liquidity in 1--3-year and 3-6-year swaps. This would avoid drawing potentially inaccurate conclusions that 10-year OIS swaps are liquid based on the liquidity of shorter durations, when in reality they may not be at all.
- This has the potential to produce anomalous rates where liquidity varies and distorted spot curves and giving rise to significant discontinuities in the forward curve, unless additional smoothing is applied. This will be particularly acute in the event that one tenor bucket has a high allocation to IBOR+CRA swaps and the adjacent bucket has a very high allocation to OIS swaps.

#### Q6. Do you agree with the proposal of EIOPA implementing option 2?

No, Insurance Europe does not agree with the proposal to implement option 2 as the common approach.

As noted above, Insurance Europe considers that it is inappropriate to decide on a one-size fits all approach to the transition given the idiosyncratic features of the different markets that could be affected.

See also the two alternatives that have been outlined in response to Q7 below.

#### Q7. Do you think there can be another alternative EIOPA needs to consider regarding the blending of the curves? Please provide an explanation.

**Alternative 1:** EIOPA publishes the two curves for a window of transition (eg. one year). Firms are then able to select the most appropriate curve until the use of new rates by that firm reaches a critical mass (50%) and then they can opt to use the alternative curves.

This would allow fewer system changes and have the advantage that liabilities and capital are only sensitive to one risk-free rate structure at a time, enabling firms to better manage their basis risks. To provide transparency on this, firms should disclose which basis they are using at each quarter-end during the transition period.

**Alternative 2:** A linear glidepath over X-months (eg. 6 months) between the old and new curves is implemented. Using a blended approach, this would apply a schedule of fixed weighting factors to ensure a gradual transition.

There would be the added advantage of up-front clarity about the timing of transition and this would, to some extent, limit the ability of banks to price against insurers. However, unlike Alternative 1, firms would not be able to hedge the curve directly.

Another advantage is that this would avoid the "chicken and egg" problem where longer tenor swaps will only be actively traded once they are incorporated into the Solvency II RFR.

A pre-mapped glidepath approach might be considered as conflicting with the following statement: "It has to be noted that IBOR transitions is a market driven change. EIOPA's RFR methodology seeks to reflect current market conditions rather than leading them in order to continue producing consistent RFR term structures." However, this statement underestimates the impact of the insurance sector on the (long-end) liquidity of the interest rate swap market.

It remains to be seen which approach would be the most optimal in each affected market. Flexibility to adopt different approaches for different markets should remain an option until the development of IBOR rates in each market is better understood.

**However, for the transition for GBP risk-free rates which is expected during 2021, Insurance Europe highlights a preference for Alternative 1.**

**Q8. Do you agree with the proposal of EIOPA to set a trigger at 85% of the total volume traded, prior to a complete shift to the new OIS term structure?**

Insurance Europe does not agree that a simplistic trigger of 85% of the total traded volume is an appropriate mechanism to finalise the transition to an OIS-based curve.

It is agreed that it is undesirable for any blended curves to retain a small portion of the IBOR swap rates for an extended period of time.

However, without any practical experience of the transition and considering the range of possibilities regarding the cessation of IBOR rates in different markets, it is too early to agree on a fixed mechanism at this stage. In addition, it may not be appropriate to rely on a single indicator for the transition. In certain cases, for example small markets, there could be a need for an expert judgement.

Additional consideration when assessing this issue are:

- Whether the percentage of total traded volume is the most appropriate metric to use?
- How does the approach take account of the completeness of the term structure? For example, an 85% trigger might be hit even though the volume in the OIS at certain key maturities still remains lower than that of the legacy IBOR rate.
- In light of the above, would DV01 provide a better metric as it would reflect the maturity of the swaps as well as the notional?

How does the 85% trigger interact with the DLT assessment? Eg. will IBOR-swaps continue to be DLT compliant if they represent just 15% of the total traded volume? Note this issue could be especially significant for smaller markets.

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