Svensk Försäkring

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Do not change the corridor for the symmetric adjustment to the equity risk charge

Insurance Sweden[1] urges the Commission not to widen the corridor for the symmetric adjustment to ± 17 % in accordance with EIOPA's proposal.[2] An increased corridor will lead to higher volatility in the capital requirement for equities that will, among other things, result in unwarranted disincentives to equity holdings as well as negative implications for the policyholders. A change of the corridor will have significant negative consequences for insurance companies, such as the Swedish, with large holdings of equities and is, thereby, in conflict with the ambition in the Capital Markets Union to promote long-term investments in equities by insurance companies. In addition, we support Insurance Europe's view that the symmetric adjustment should be optional to apply.

As a member of Insurance Europe, we strongly support the views expressed in Insurance Europe's position paper on EIOPA's proposals on the 2020 review of Solvency II.[3] However, we wish to highlight and elaborate from a Swedish perspective on EIOPA's proposal to widen the corridor for the symmetric adjustment to the equity risk charge. We would also like to clarify Insurance Sweden's strong position against such a change.

Increased corridor for the symmetric adjustment has negative consequences for Swedish insurers due to large equity holdings

On average one third of Swedish insurance companies' assets consist of equities, which is the largest share of equity holdings among European insurance companies.[4] A change of the corridor will, therefore, have significantly larger implications for Swedish insurance companies than for most other European companies.

The composition of EIOPA's equity index used to estimate the symmetric adjustment often differ materially from the actual equity exposure for an insurance company and, thereby, distort the effect of the measure. This is a phenomenon

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[1] Insurance Sweden is an industry organization that represents about 50 Swedish insurance companies, which together account for more than 90 per cent of the Swedish insurance market. Insurance Sweden is a member of Insurance Europe and strongly supports and participates actively in its work.

[2] See EIOPA (2020), Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/749).

[3] Insurance Europe position paper on EIOPA final opinion on the SII 2020 Review final draft, submitted to the European Commission by 12 March 2021.

[4] See e.g. Figure 5.7 in EIOPA (2019), Financial stability report December 2019.

which is often referred to as basis risk. This problem with the symmetric adjustment is also recognized by, among others, EIOPA.[5]

Swedish insurers' equity exposures differ from EIOPA's index in that a large share, above 60 per cent[6], of equity holdings is in Swedish equities, mainly to avoid currency risk. Even though the Swedish stock market has a relatively high weight (8 per cent) in EIOPA's index, the big difference between the actual holding of Swedish insurance companies of Swedish equities and the weight in the EIOPA index persists and creates basis risk.[7] The basis risk can be even higher for other European insurance companies, because many countries have higher home bias among their insurers.[8] On the other hand, the consequences of EIOPA's proposals will probably be worse when, as for the Swedish insurance companies, the majority of the equity holdings, including e.g. holdings belonging to unit-linked policies, are denominated in non-euro currencies due to the composition of the reference index.

A widening of the corridor will further increase this basis risk for Swedish and other European insurance companies, which in turn can lead to unwarranted situations where the level of the capital requirement to a larger extent does not reflect the true risks of the company's equity exposure. This will have an even more substantial effect if the companies, as the Swedish, have large equity holdings. It is also important to note that the symmetric adjustment is also applied to equity type 2 exposures, which often differ more from EIOPA's index in terms of risk and realized returns than type 1 exposure.

These effects are already present with a corridor for the symmetric adjustment of ± 10 %. However, the negative effects will become more severe if the corridor is widened to ± 17 %. This might not be a big issue in bad times (i.e. bear markets). However, in good times (bull markets) it could be a drastic increase of the symmetric adjustment, but at the same time very limited increase in the value of the company's actual holdings of equites. Thus, the SCR-ratio will go down in such cases and this peculiar effect will be even more pronounced if the corridor is widened to 17 %. A decrease in the SCR-ratio can lead to situation where the insurers may have to "fire sale" equities in good times, which will in the end have negative effects, e.g. on policyholders' pension savings.

A situation with drastic increase of the symmetric adjustment, but at the same time limited increase in the value of the company's holdings of equites is highly plausible. Even though the correlations between different stock markets and the EIOPA's equity index were high (close to +1) during the global financial crisis 2007 – 2009[9] this will, however, not always be the case. For example, the U.S. and Swedish stock markets have been on record levels during the fall and winter 2020/21, while the stock markets in the Eurozone and U.K. still have not fully

[5] See e.g. EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/749).

[6] See e.g. Figure 5.14 in EIOPA (2019), Financial stability report December 2019.

[7] For a discussion about the weights in EIOPA's index, see, e.g. section 2.10 in EIOPA (2019), Consultation Paper on the Opinion on the 2020 review of Solvency II, EIOPA-BoS-19/465.

[8] See Figure 5.14 in EIOPA (2019), Financial stability report December 2019.

[9] See e.g. EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/750).

recovered from the market turmoil during Spring 2020. This suggests that the correlations between different stock markets and EIOPA's equity index can vary over time and also between different crises.

In addition, the correlations among stock markets tend to increase during a crisis and the correlations during normal and good times are often significantly lower. Before an increase of the corridor is considered a thorough analyze of the correlations between EIOPA's index and insurance companies' equity holdings should, therefore, be conducted in both good and bad times, and not just in bad times.

Increased corridor will lead to overshooting

With a corridor of ± 17 % the capital requirement for equities can deviate by nearly 50 per cent up and down from the default value (e.g. 39 % for Type 1 equities). Such large swings in the capital requirements can have large effects and contra-intuitive effects on the SCR-ration. For example, the SCR-ratio might increase when there are large declines in the equity market. That can already happen with the current corridor, which, for example, was a major reason why the average SCR-ratio for Swedish insurers increased during Q1 2020 in spite of the sharp fall in the equity prices. The average SCR-ratio for Swedish insurers increased from 261 % to 266 % during the first quarter 2020, while the Swedish stock market fell by around 20 per cent during the same period.[10]

ESRB has recently expressed such concerns and argue that it is counter-intuitive that the SCR ratio of some insurers increased in the midst of the COVID-19 crisis due to the volatility adjustment (VA).[11] Also EIOPA has observed this phenomena, and has attributed it to an overshooting effect of the VA for some countries.[12] Therefore, one of EIOPA's proposed changes of the VA in the 2020 review is motivated by a will to mitigate the overshooting effects of the current VA.[13]

Just one of 128 Swedish insurance companies apply the VA. Thus, the increase in Swedish insurance companies' SCR-ratio during the first quarter of 2020 is not due to the VA. Instead the main reason for this increase is the symmetric adjustment together with Swedish insurance companies' large holdings of equites.[14] Thereby, there is also an overshooting for the current symmetric adjustment. This is something also EIOPA has observed, but according to EIOPA this phenomenon was only observed for non-life undertakings.[15] However, in EIOPA's own statics the average SCR-ratio increased both for Swedish non-life and life insurance companies during this period.[16]

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[10] See EIOPA's Insurance statistics.

[11] See ESRB (2020), Response letter to a consultation of the European Commission on the review of Solvency II (19 October 2020).

[12] EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/750).

[13] EIOPA (2020), Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/749).

[14] Finansinspektionen (2020), Aggregate statistical data with regard to insurance and reinsurance undertakings supervised under Directive 2009/138/EC.

[15] See e.g. EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/750).

[16] EIOPA (2020), Insurance statistics.

With a widened corridor the symmetric adjustment would have been - 13,07 % at the end of March 2020 instead of - 10 %. Somewhat simplified calculations suggest that the average SCR-ratio for Swedish insurers would have been at least around 275 % Q1 2020 if the symmetric adjustment would have been - 13 %, That would imply an increase of the SCR-ratio by around 10 percentage in comparison to a symmetric adjustment of – 10 %.[17]

Thus, a widened corridor would have increased the SCR-ratio of Swedish insurance companies even further during a period of large declines on the stock markets in Sweden and elsewhere, i.e. even more overshooting. That means that there will be a higher risk of overshooting effects from the symmetric adjustment and larger magnitudes of this phenomenon if the corridor is widened. To be consistent, any concerns of overshooting for the VA should also be recognized for the symmetric adjustment. With the current corridor this overshooting for the symmetric adjustment is manageable. But with an increased corridor there will most likely be severe consequences as the overshooting will be much larger. Notably, EIOPA has not presented any analysis of the consequences of a widening of the corridor.

Increased corridor will lead to specific problems for unit-linked and similar products

Furthermore, insurers with mainly unit linked and depository insurance[18], i.e. products where the policyholders decide on allocations between investment funds, must apply the symmetric adjustment. The objective of the adjustment, to reduce the volatility of own funds, is totally failed in such cases since the policyholders are not directly affected by any capital requirements, and totally unaffected by the symmetrical adjustment in their investment behaviour.

In fact, even for insurers with mainly unit linked and depository insurance the symmetrical adjustment can lead to materially worsened solvency in good times (bullish markets), an effect that would increase if the corridor of the symmetric adjustment is increased.[19] Thus, for savings products where the policyholders decide on the allocations, e.g. unit-linked insurance, this adjustment has no effect on the insurance companies' investment behaviour and it substantially increases the Solvency ratio volatility, without the possibility for the insurance companies to mitigate the effect by selling equities. Therefore, we strongly support Insurance Europe's position that it should be optional for the insurance companies to apply the symmetrical adjustment.[20]

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[17] In these calculations it is assumed that on average 40 % of the Swedish insurance companies' SCR is equity risk. This is in line with statistics published by the Swedish FSA.

[18] In Swedish depåförsäkring, often also referred to as 'portfolio bonds'.

[19] A somewhat simplified simulation conducted by a Swedish insurer on its portfolio (mainly unit-linked) when it is assumed an initial situation with symmetrical adjustment of 0 % and an immediate stock market increase of 35% shows that 1. no symmetrical adjustment, the SCR-ratio will decrease by 10 percentage points, 2. a symmetrical adjustment with a corridor of ±10 %, the SCR ratio will decrease with about 20 percentage points, and 3. a symmetrical adjustment with a corridor of ±17 %, the SCR ratio will decrease with about 30 percentage points.

[20] Insurance Sweden has also previously highlighted the problems for unit-linked and similar saving products with the symmetric adjustment, see for example Insurance Sweden's response to EIOPA's Consultation paper on the Opinion on the 2020 Review of Solvency II (January 2020). Can be found here: https://www.svenskforsakring.se/contentassets/44c4b5cc304a49d1b8064a70da6800a7/svensk-forsakrings-svar-pa-eiopas-remiss-om-2020-oversynen.pdf .

Increased corridor is in conflict with the ambition of CMU

To sum up, there are several drawbacks with a widening of the corridor for the symmetric adjustment to the equity capital charge. In addition, we believe that there are other factors that are more important for insurance companies not to be forced to "fire sell" equites during market turmoil than the symmetric adjustment. Swedish insurers' strong solvency position before the COVID-19 pandemic is the main reason why the holdings of equities were more or less constant during the first quarter of 2020.[21]

The higher volatility in the capital charge for equites that an increased corridor will imply, will make it more difficult to maintain the current equity exposure for Swedish insurance companies and other insurance companies with large equity holdings. The possibilities to increase equity investments will also be severely impaired. Thus, a widened corridor goes against the ambition to promote long-term investment by insurance companies in the Solvency II review, as stated in the European Commission's new action plan for the Capital Markets Union.[22]

Thereby, there are several reasons why the corridor should be maintained, but hardly any reason why the corridor should be widened in accordance with EIOPA's proposal. Instead, the corridor for the symmetric adjustment should be kept at ±10 % In addition, the symmetrical adjustment should be optional for the insurance companies to apply.

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[21] Statics Sweden (2020), Swedish insurance companies, capital investments 2nd quarter 2020 (quarterly net transactions). In this statistic it is not possible to separate investment funds from equities. However, a majority of these funds are equity funds. Assets that belong to unit-linked and depository insurance are excluded from the equity holdings.

[22] Action 4 in European Commission (2020), A Capital Markets Union for people and business – new action plan, COM (2020) 590 final.