EIOPA-IRSG-18-32
11 December 2018

EIOPA's Request for Feedback on Methodological Considerations regarding Illiquid Liabilities

Opinion by the

EIOPA Insurance and Reinsurance Stakeholder Group

General comments

- **The purpose of the illiquidity study is not sufficiently clear**. EIOPA should clarify how it envisages the illiquidity indicators will be used in the development of future regulatory changes.

- **The appropriate starting point should be on whether or not assets are exposed to losses on forced selling**. This changes the nature of the asset risk to which the insurer is exposed. For assets where there is potential forced selling, the risk the insurer is exposed to is losses due to price volatility. Where there is no material potential for forced selling, the insurer can earn an illiquidity premium but is exposed to the risk of long-term under-performance of the asset.
  - **Where an insurer's ability to hold assets over the long-term can be reliably demonstrated, the Solvency II framework should reflect this;** their ability to earn an illiquidity premium should be reflected in the discount rate used to value liabilities and their capital requirements should reflect the true risk of long-term investing.
  - **For bonds, where forced-selling can be avoided, the relevant risk is the default risk over the full maturity, not the price or spread risk.** Migration risk is only relevant for calculation of the right default rate and not for assuming the insurers are forced to replace down-graded assets at a loss.
  - **For equities, which constitute a prudent portion of the total portfolio and where forced-selling can be avoided, the relevant risk is the long-term underperformance, not the risk of losses from selling after a market crash.**
- **In this context, we support further investigation of the following issues**:
  - The means of allowing for additional yield on illiquid assets backing illiquid liabilities. Particular issues to consider might be the extent of investment restrictions (MA) and the limited nature of the VA adjustment together with the basis risk inherent in the use of a representative portfolio approach.
  - Whether the standard formula SCR calculations treat illiquid liabilities appropriately by being based on short-term price risk rather than long-term underperformance.

- **The illiquidity of liabilities is only part of the process for assessing if there is potential for forced-selling.**
  - **Overall liquidity and illiquidity can only be assessed by looking at the liabilities together with the assets and other sources of liquidity i.e. overall Asset Liability Management (ALM)**
  - **Long-term illiquid liabilities and recurring business provides insurers with a stable balance sheet which enables them to invest in long-term assets of illiquid nature without exposure to forced selling at potential losses**. The ability to hold such assets over the market cycles is a key feature of the insurance sector that contributes to the supply of stable long-term financing of the real economy.
  - **An insurer's liquidity needs are a real-world requirement.** The prudential framework must reflect the real-world risks and real-world ALM not an ivory tower theoretical world. In the real world of insurance, liquidity assessment needs to reflect the ability of own funds to support long-term investment, contract boundaries, new sales, re-insurance and hedging programs (e.g. interest rate, equity or currency), etc.

- **Neither the duration of liabilities nor the holding period for individual securities can be used as general indicators of illiquidity or potential for forced-selling.**

Comments with regard to methodologies discussed in the questions

- **We are not aware of evidence of a correlation between a company's Solvency Ratio and the tendency of policyholders to lapse their contracts.**

- **Any illiquidity indicators should capture the degree to which the liability cash flow profile is stable.** This stability is, in part, influenced by the policyholder options provided in terms and conditions of underlying contracts but more importantly by incentives to actually invoke such options as measured by historical experience with lapse rates.

- **A well-designed liquidity stress test should yield a better indicator of the predictable part of the insurance liabilities**. The liquidity shock arises primarily from policyholder lapse behavior and therefore should be modelled independently from any market, mortality or longevity scenarios unless a strong correlation of policyholder behavior with these risks can be evidenced from historical data.

- **The holding period of individual assets is not relevant – only if they are exposed to losses on forced-selling.** We also note that the use of Solvency II data to assess long-term investment is not appropriate as it only covers the past three years with the 2016 data being of lesser quality.

- **Prudential measures must not impose restrictions on insurers' ability to manage their portfolio and change individual assets**. Insurers actively manage their asset portfolio to manage concentration risk, enhance yields, rebalance due to change in liability profiles, etc. and consequently asset turnovers are not usually driven by the (unexpected) need to cover liability cash flows (forced selling), but by optimization to the benefit of policyholders and shareholders.