Interinstitutional files:
2017/0230(COD)

Brussels, 14 March 2019

WK 3753/2019 INIT

LIMITE

EF
ECOFIN
CODEC

WORKING PAPER

This is a paper intended for a specific community of recipients. Handling and further distribution are under the sole responsibility of community members.

WORKING DOCUMENT

From:	Commission services
To:	Working Party on Financial Services (ESFS Review)
Subject:	The Volatility Adjustment in Solvency II - Commission services non-paper

Commission Services Non-Paper

DISCLAIMER
This draft has not been adopted or endorsed by the European Commission. Any views may not in any circumstances be regarded as stating an official position of the Commission. The information transmitted is intended only for the Member State or entity to which it is addressed for discussions and may contain confidential and/or privileged material.

The Volatility Adjustment in Solvency II

The volatility adjustment is a component of the discount rates for insurance liabilities under Solvency II. The volatility adjustment aims to "prevent pro-cyclical investment behaviour" (Recital 32 of Directive 2014/51/EU). It is by default calculated at the level of currencies. For Member States of the Euro Area, the volatility adjustment can be increased by a country component, where the following two conditions are met on the reference date for the financial statement (Art. 77d(4) of Directive 2009/138/EC):

(i) the risk-adjusted spread for the country is at least twice as high as the risk-adjusted spreads for the Euro Area (relative threshold); and
(ii) the risk-adjusted spread for the country must be 100 basis points or higher (absolute threshold).

The financial statements are prepared according to a quarterly cycle. The activation or an absence of activation of the country component can have a significant impact on the own funds of the insurance companies in the respective countries.

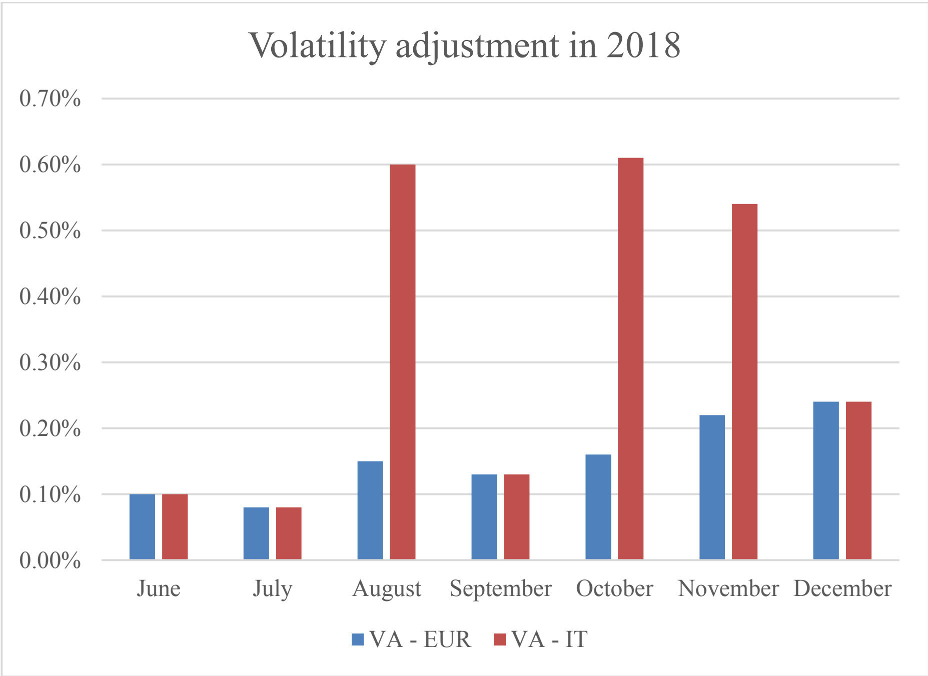
Unintended consequences of the country component

With the current mechanism, the country component can alternate between activated and not activated between two reference dates. In fact, this has been observed under the current market environment for Italy over the past months. The alternation between activation and absence of activation leads to volatility in own funds for the insurers in the country and therefore contradicts the aim of preventing pro-cyclical behaviour. As a consequence, the volatility adjustment cannot produce its intended effects.

The chart below illustrates the alternation between activation and no activation for the country component of the volatility adjustment for Italy from June 2018 to December 2018. While the country component was activated for the months August, October and November, it was not activated during the other months and the Euro volatility adjustment without any increase applied for Italy. When activated, the difference in volatility adjustment ranged from 32 basis points in November to 45 basis points in October and August.

While the relative threshold was exceeded throughout the entire period, the risk-adjusted country spread for Italy has been moving around both sides of the absolute threshold. In spite of continuous large relative differences between the risk-adjusted spreads in Italy and other countries of the Euro Area, the country component was not activated during several months. The risk-adjusted country spread fell short of the absolute threshold on the reference date despite small changes in financial markets. A striking example was observed in December, when the risk-adjusted spread for Italy was 99 basis points and hence the country component could not be activated, leading to a drop of the

volatility adjustment for Italy from 54 basis points to 24 basis points. The drop in the volatility adjustment reduces the own funds of insurance companies to a significant degree.



Conclusions

The current activation of the country component of the volatility adjustment leads to undesired effects.

In order to address those structural problems effectively, a fundamental review of the volatility adjustment is necessary under the 2020 review of the Solvency II Directive to allow it to produce its intended effects. The Commission has already invited the European Insurance and Occupational Pensions Authority to provide technical advice on this issue.

In the meantime, a reduction of the absolute threshold set out in Art. 77d(4) of Directive 2009/138/EC is necessary to mitigate temporarily the cliff edge effects implied by the current activation mechanism until the fundamental review in 2020.