

Market risk correlation assumptions in the Standard Formula SCR

QIS 2 feedback

Concerns were expressed by many firms about the significant correlation assumed between a number of the components of the market risk component in the standard formula SCR, in particular those between equities and property, and between equities and interest rates. We recognise that it would be sensible to review the appropriateness of these correlation assumptions, bearing in mind though that these are intended to relate to the likely correlations in stress conditions (i.e. 1 in 200 year events).

Background to the issue

The QIS2 calibration of market risk correlations was based on analysis performed for the Dutch regulator in developing its proposed supervisory regime for insurers and pension funds. This led to correlation coefficients as follows:

Equity/ interest rates: +0.75

Equity/property: +1

We are mindful of the Deloitte's report for ABI on key correlation assumptions for ICAs which showed indicative ranges for assumptions as follows:

Equity/ interest rates: -0.25 to +0.1

Equity/property: 0 to +0.4

The issue is difficult to address as the correlations appropriate for the SCR are those appropriate in 1 in 200 year stress events. In view of the rapid changes in markets over recent decades the data series available can only provide relatively little support for such remote events.

CEIOPS

Within CEIOPS we have raised the need for further work on these assumptions. We are proposing that the CEIOPS October consultation paper should refer to this aspect of the proposals and recognise that there is an issue here that needs further investigation. Input from Sweden indicates that the Swedish industry also considers the equity/ interest rate correlation should be reviewed.

Firms' input

We would be happy to receive evidence from firms to support the assumptions which they would suggest for the standard formula. Please respond to Ian Pickering by 31 October.