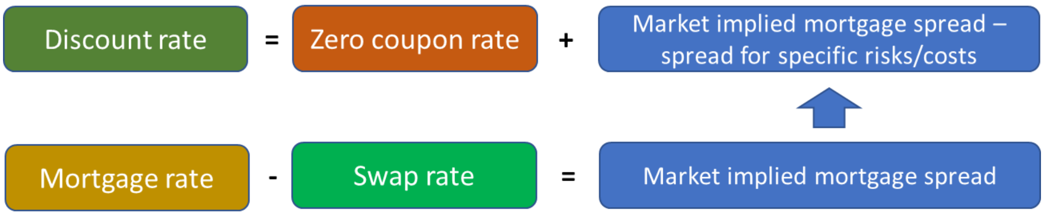
Annex 1 to the Dutch Association of Insurers' response to the EIOPA consultation paper on the 2020 Review

Para 2.260
EIOPA has carried out an intensive review and as a result highlighted several deficiencies. However, EIOPA did not assess the appropriateness of including all possible investments when determining the VA. One of the asset classes which is not included properly for the Dutch market is mortgage loans.
In some Member States (e.g. the Dutch market) the mortgage loans are a significant part of the investments backing the insurance liabilities. Because of the materiality of the allocation of mortgage loans, mapping them to corporate bonds is not an appropriate simplification (as applied by EIOPA) anymore, especially considering the low correlation between mortgage spreads and corporate spreads.
Mortgage loans are specific investments. In the Dutch market direct mortgage loans are not listed (The mortgage loans on the balance sheet of Dutch insurance companies are almost completely direct mortgage loans and thus not structured assets.). The counterparties of mortgage loans are individual consumers, some of which also have an insurance policy related to their mortgage loan. The mortgage loans are an important instrument in hedging the interest rate risk arising from insurance liabilities and are therefore generally held to maturity (so no intermediate sale), so insurers have no objective to benefit from short term price fluctuations. Furthermore the default rates from Dutch mortgage loans, on average, are very low (this was also seen during the credit crisis of 2008-2010).
Under the current approach mortgage loans are allocated to corporate bonds.
Our proposal for treatment of mortgage loans in the VA is to use a separate mortgage index. As mortgage loans are not traded on an active market and no quoted prices exist, obtaining an economic value is based on a market-to-model valuation methodology. The valuation methodology can either be based on a top-down approach or bottom-up approach. The latter involves more entity specific assumptions and possibly expert judgment.
For this proposal we refer to the "top-down approach" (with the benefit that this approach is widely used in the Dutch market). Under the top-down approach the spread is derived from market data.



Market rates for mortgage loans can be obtained from the consumer market for mortgage loans. The mortgage rates from providers should be assessed for their quality . From this rate the "swap rate" is deducted to arrive at the "market implied mortgage spread".
From the "market implied mortgage spread" costs are deducted which are not relevant to the valuation of an existing mortgage loan. These costs include (non-exhaustive):

- Pipeline risk.
- Pipeline risk is defined as the Interest rate Risk which exists for an issuer between the moment of putting forward a proposal to a consumer and the settling of this proposal in a legal manner. In principle the pipeline risk is determined as the cost of buying an Interest Rate Swap (IRS) in which the fixed leg is the mortgage loan interest rate as put forward and the floating leg is Euribor (or an equivalent benchmark). The IRS is obtained for a similar period for which the pipeline risk exists;
- Marketing and Sales;
- Servicing at origination.

For each Member State this exercise can be performed, based on which an index per Member State (where appropriate considering the size of the mortgage holdings of the insurers) can be constructed where mortgage loans are a significant part of the investment mix and included in the determination of the VA.