Review of the Solvency II long-term package

Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Solvency II: a modern risk-based supervisory framework

The implementation of Solvency II, in January 2016, marked a shift in the way that solvency is assessed, moving beyond a purely capital-based perspective. Solvency II introduced new capital management and disclosure requirements. It also introduced governance and risk management as a central pillar of the framework. These requirements were designed to make sure that insurers are ready to meet their customers' obligations, under any circumstances, including extraordinary events such as a global financial crisis or a natural catastrophe.

Together, these new requirements have resulted in a more preventive and risk-based approach to solvency, which have increased the overall soundness of the insurance sector.

Insurers now have to consider and be prepared for all types of risk that they might face. Through tools such as the Own Risk and Solvency Assessment, the ORSA, insurers have significantly strengthened their governance models and risk management capacity. Boards now consider risk and capital factors in their strategic decision-making.

Enhanced reporting requirements have resulted in improved legibility, transparency, reliability and comparability of insurance companies' risk profile. The use of harmonised templates for supervisory reporting and the public disclosure of more information means greater transparency for the industry and is the basis for better market discipline.

More broadly, the Solvency II framework has modernised the supervision of the insurance industry, driving towards a consistent approach to supervision across Europe. Supervision is evolving towards a stronger and stronger evaluation of risk and risk management. Supervision is also evolving to take into account the increase in cross-border business.

Solvency II is not, however, 'one size fits all.' To reduce the burden on smaller insurers, the notion of proportionality runs through the regulation. This helps to ensure fair competition between insurance companies across Europe whatever their size.

All this means that consumers are better protected. Across Europe, consumers enjoy similar levels of protection, no matter where they are based or from where they buy insurance. Consumers can also have greater confidence in their insurance products, the insurers and the financial system as a whole.

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>>> In the three years since the implementation of Solvency II, the insurance industry has better aligned capital to the risks it runs using a risk based-approach to identifying and managing risk.

For the legislation to remain effective, it must remain relevant and therefore the subject of regular review. From the outset, two reviews have been built into the Directive. The first review has already started. Last year, EIOPA delivered technical advice to the European Commission on the review of the Solvency Capital Requirement. The advice was based on an in-depth analysis of 29 different elements and focused on increasing proportionality, removing unjustified constraints to financing the economy and removing technical inconsistencies.

The second review, which will conclude by the end of 2020, will look at more broader issues so that the framework can be adapted to new market conditions, while maintaining the principles underpinning the risk-based regime and consumer protection. EIOPA will review issues related to long-term guarantee measures, illiquid liabilities, reporting and public disclosure requirements, supervisory tools and measures needed to reinforce the macro-prudential nature of Solvency II and sustainability considerations. Insurance plays an important role in Europe's economy. Assets represent a significant amount of the European Union gross domestic product; insurance companies employ large numbers of staff; and most citizens rely on some form of insurance as protection against unwanted or unforeseen events. The failure of any insurer brings with it the possibility of disruption to the provision of financial services, the economy and, of course, people's lives.

In its capacity as a European Supervisory Authority, EIOPA will continue to supervise the implementation of Solvency II and present recommendations for its improvement, so that consumers and businesses can continue to benefit from a well-functioning and stable financial system. •

Clément Michaud

Chief Financial Officer, Crédit Agricole Assurances

Solvency II, facing the long-term investment challenge

2019 is a turning point for the future of European integration. Going forward, the responsibility of political and economic leaders is immense as we must collectively bring solutions to European citizens. Work on the delegated act of Solvency 2 was an opportunity for all stakeholders to carry out an initial assessment of the implementation of this Directive and to think about potential evolutions. The review of the Directive provides us with an opportunity to complete this process so that insurers can provide concrete solutions to address today's economic, financial and societal challenges.

The insurance sector has indeed a leading role to play in building a Europe that protects its citizens, and, at the same time, invests in the productive economy. The prudential framework must be adapted by credible proposals so that insurers can fully endorse this dual role.

The first challenge is to incentivize insurers (whose role is to assume risks) to invest more in diversified assets in order to provide savers with more yields. To achieve this, the risk framework should take into account the real horizon of their investments instead of systematically setting a penalizing cost of capital. The European Commission's >>>

>>> recent proposal on the long-term equity class goes in the right direction, but is not enough to fill the investment gap in companies' capital. The euro fund responds to citizens' need of having a guaranteed investment product and allows insurers to pursue a long-term investment strategy in the economy (equities, infrastructure, etc.). It is crucial in this regard to strengthen this financing tool, in particular within the framework of the Capital Markets Union project.

The second challenge is to ensure that the calibration of SCR calculation parameters is a process based on relevant impact studies, to anticipate their consequences for the financing of the economy. The case of the interest rate risk sub-module is very telling because it can easily disrupt the balance sheets of insurers, which are mainly composed of interest rate financial products. As a result, any change in the interest rate risk sub-module modeling would have significant consequences that could affect insurers' investment capabilities.

Another important challenge remains the fight against climate change, a key topic on which citizens expect political and economic leaders to assume their responsibilities. The insurance risk framework should indeed reflect the integration of climate risk into investment decisions. Building on discussions around a risk based Green supporting factor in the banking regulation, the pillar 1 of Solvency 2 could be amended to further encourage insurers to hold green assets and better take into account the risk associated with climate change. Green assets could be defined on the basis of a harmonized taxonomy that must be simple in order to allow efficiency and transparency in its application.

If we want to gain a comprehensive view of the factors for long-term investment improvement and volatility correction, accounting regulations should not be set aside. IFRS 9 is an international reporting standard which introduces a Fair Value classification and measurement of finance assets – the unrealized gains and losses of equity products are recognized either (1) in the P&L, which gives it a very high volatility, or (2) in non-recyclable OCI (no volatility but no performances). CAA has been applying IFRS 9 since early January 2018 and has been witnessing a very high volatility of its P&L – that we were able to correct with the "Overlay". Without this transitional measure, we would have been forced to "de-risk" our portfolio. Thus, we think that the recycling of realized gains or losses should be reintroduced and required upon sale of the equity instrument as accumulated gains and losses in OCI are part of the performance of LT investments.

Finally, preparing the entry into application of IFRS 17, we realized in our simulations that our P&L is subject to a much higher volatility than under IFRS 4.

At Crédit Agricole Assurances, we believe that European insurers can play a leading role in meeting the challenges of a European Union that defends a model of sustainable, long-term and less volatile growth at the service of its citizens. Prudential and accounting regulations must, more than ever, strive towards these objectives. ●

Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

Solvency II – our goals for the upcoming revision

You might ask: "Why is Solvency II already being reviewed just three years after it came into force?" The answer is quite simple: because this is what the Directive states, requiring the Commission to review certain elements of Solvency II in 2020. This affects long-term guarantees and measures to counter equity risk, the calculation of the solvency capital requirement (SCR) using the standard formula and the advantages of enhanced group supervision, but also the appropriateness of reporting and the issue of "proportionality". The Commission is now asking EIOPA for technical advice about these and other issues.

BaFin will play an active role and put forward its proposals in the working groups that EIOPA has established for this purpose. There are several issues that are of particular concern to me: for BaFin, it is imperative for insurers to continue to be able to offer >>>

>>> contracts with long-term guarantees. This requires that the necessary capital be calculated such that it is commensurate with the risk. Procyclical effects should therefore be avoided and appropriate account must be taken of the insurers' investments with a long-term horizon. I also think there is a considerable need for improvement with regard to the issue of "proportionality". We already use the scope available to us to the best of our ability. However, it is evident that the framework within which supervisors and undertakings are allowed to move here also has to keep pace with growing experience. Further opportunities for flexibility should be created. Supervisors must always be able to order a particular undertaking to comply with all the requirements on the basis of its risk profile. But I also see a need to simplify some of the reporting requirements and to reduce their scope. BaFin is advocating a tougher prudential reporting regime. We want to scrutinise all of the templates and ask whether they are suitable for achieving the relevant supervisory objectives. If the answer is "No", they either have to be modified accordingly or removed. BaFin believes that reporting should be expanded in some areas.

"It is imperative for insurers to continue to be able to offer contracts with long-term guarantees."

\- DR. FRANK GRUND

Once the work is completed, reporting should overall be leaner and more focused. I hope that we will win support for this work and that our idea of what the outcome should look like will be shared in the European context.

"Better is the enemy of good" also applies to the SCR. The standard formula must be simpler without this negatively impacting risk sensitivity. This sounds rather like squaring the circle, but I also see some leeway here, for example in the simplification of the requirements for calculation modules that are not regarded as material. I also expressly support the recommendation by EIOPA to the European Commission to reassess interest rate risk. The current standard formula does not acknowledge negative interest rates and has thus become decoupled from both reality and the internal models. This imbalance must be removed. But I would also like to observe that the calculation of the solvency capital requirement may not be allowed to become the plaything of political interests.

To sum up, there are many issues that we will address actively with the aim of making the Solvency II rulebook more commensurate to the risk and giving it a more practical design. ●

Tobias Bücheler

Head of Regulatory Strategy, Allianz SE

An evolution of Solvency II to promote growth, effective old-age provision products and financial stability

With the recent all for advice on the 2020 review by the EU Commission, the further development of Solvency II has entered its decisive phase. The call includes amongst other key issues also an assessment of the volatility adjustment as well as an analysis regarding the extension of macroprudential measures in Solvency II.

The review is performed against a background of large-scale discontinuation of traditional guarantee products and the rise of new products that push investment risk back to policyholders. The reassessment of bond spreads of some European countries during 2018 illustrated on the other hand strikingly the relevance of the supervisory framework from a macroprudential perspective.

While we believe that the upcoming regulatory reform should avoid to unravel Solvency II fundamentals, it should on the other hand consider the real risks and opportunities of long-term stable investing, remove unwarranted conservativism and carefully finetune Solvency II to address relevant risks.

More specifically, the role of the insurance sector as a stable long-term investor should be better recognized. The (life) insurance business model is by nature long-term and related long-term insurance liabilities can ideally be covered by long-term assets. As such, the most prominent risk is a potential asset default. In contrast, short-term market price fluctuations are largely irrelevant. Unfortunately, insurers are treated under the current Solvency II framework more like traders whose assets may have to be sold quickly to settle short-term liabilities. In contrast, insurers typically don't need to sell assets quickly as they receive liquidity from regular premium inflows, yield and dividend income as well as maturing assets.

Solvency II acknowledged the issues above in principle with the introduction of the so-called Volatility Adjustment aiming to mitigate the impact of asset spread movements on the solvency situation of insurers thereby improving financial stability. Unfortunately, after more than 2 years of experience with the Volatility Adjustment one can only describe its impact as „too little, too unspecific". It even introduces additional basis risk into the system if an insurer's portfolio does not fully match the reference portfolio set by EIOPA. In contrast, an enhanced Volatility Adjustment that acknowledges the insurer's actual investment portfolio (which is insulated from short-term liquidity needs) would much better reflect the underlying risk assuming that related default risk is recognized in capital requirements and relevant prudential limits are observed.

We believe that economy and society would benefit from an improved Volatility Adjustment twofold: Firstly, it would enable the sector to invest more into long-term assets matching its liabilities. This would support growth of the real economy while at the same time allowing the provision of more effective old-age provisioning products. Secondly, it would reduce pro-cyclicality thereby enhancing financial stability and possibly even reduce the need for any further macroprudential measures for Solvency II. ●

Lionel Corre

Deputy Director Insurance Division, Ministry of Economy and Finance, France

It is time to take stock of our regulations to foster long-term investment

After years of negotiations, Solvency II came into effect on January 1st 2016. Stakeholders generally agree that this new and sophisticated prudential framework significantly improved the soundness of the insurance sector.

Solvency 2 is based on the assumption that insurers should, on a fair-value basis, resist, in the year to come, to shocks that statistically happen every two hundred years. This very well depicts the situation of an insurer that would actually have to deal with those shocks on a short-term horizon, selling assets in stressed situation in order to be able to cope with its liabilities.

However, this approach has drawbacks. The main one is that it does not reflect the specificity of long-term investments detained by insurers, which are not expected to be sold, even in stressed situations.

Due to their business model, insurers are very well adapted to such long-term investments, and the prudential framework should not discourage the financing of our economy as long as those insurers are able to prove that they are not exposed to realize the losses calculated in the one-year shock. This is a question of paramount importance for the European economy, which we tried to address this year in the level 2 review, by creating a new asset class for long-terms equity investments. This new approach of equity investments is a step in the right direction. Beyond, there is still room for improvement and we will have to go further on this issue with the other co-legislators, notably within the level 1 review.

Such a reform of the prudential framework would need to be accompanied by a broader review of the regulations applying to insurers in order to be effective. For instance, the accounting treatment of equities can create various disincentives to hold this type of assets and can even discourage to have them at all. The current impact studies on IFRS 9 are important in that regard.

We will need to draw conclusions from the results from a public policy perspective, as we do not want the accounting rules to hinder the impact of what we improved on the prudential framework.

> *"Due to their business model, insurers are very well adapted to such long-term investments."*
>
> - LIONEL CORRE

As a national regulator, and European co-legislator, our mandate is also to protect our consumers and policyholders. This is why we have to take action after what we experienced in 2018 with a multiplication of collapses of cross-border businesses.

Freedom of provision of services is a pillar of the single market and a chance for Europe. But if we want to preserve it, we need to make sure that the supervision of cross-border businesses is efficient.

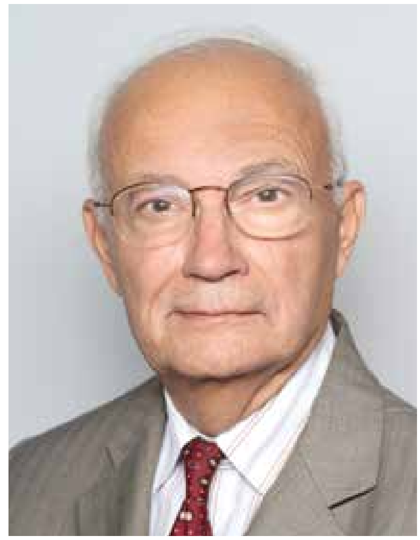
The policy holders should benefit from the same level of protection regardless of the origin of their insurers, which can be achieved only with a fair and equivalent supervision across Europe. This is why we issued proposals in the ESAs review package, together with other member states and with the support of the European parliament.

This topic should be a matter of priority for the coming years. ●

Jean-Jacques Bonnaud

EUROFI

Enlarging the capabilities of the insurance sector to invest in equity



The insurance sector is by far the main long-term institutional investor in the EEA. However, paradoxically its contribution in this area has been reduced by nearly 50% since the beginning of the financial crisis in 2007, although the EU economy shows under investment in long-term projects, including notably infrastructure ones and SMEs, contrary to what has happened in the other countries of the O.E.C.D.

The consequences of this trend on the financing of the EU economy are aggravated by the fact that banks in the EU – which provide 80% of the financing of these investments - are constrained by stricter capital requirements to better optimize their risks.

This is the general rationale of the CMU Project of the Commission, which seeks to enlarge the relative contribution of financial markets to the financing of the EU economy. However the last round tables organized by Eurofi - and notably the one in Vienna (September 2018) - have shown that the evolutions of prudential rules for the insurance sector, as featured in Solvency II, though they have improved its risk management and governance, >>>

>>> did not allow the insurance sector to increase its contribution and even according to surveys conducted by the industry showing that it is the opinion of roughly 50% of Eu insurance undertakings, had negative effects.

In particular equity financing seems penalised by the pressures of the capital charge of the standard formula, despite the context of a long-lasting period of low interest rates, deepening investment needs resulting from raising climate-related risks in the economy.

Some of the recommendations of the panellists have since been adopted in the new proposals of the Commission regarding the 2018 review of L.T.G. measures of the Solvency II, open to consultation until 7 December.

In particular the capital charge regarding certain equity investments for specific ring-fenced portfolios encompassing certain unlisted equities, are reduced from 39% and 49% to 22%. This specific treatment is subject to the criterion of an adequate diversification and thorough credit risk assessment of the investment portfolio. The proposal also includes regulatory reliefs for exposures to regional governments and local authorities. These would be concrete and effective measures.

A new review of Solvency II is programmed by the commission for 2020, and a request for advice has been recently submitted to EIOPA for the end of 2019. In this respect according to Insurance-Europe the review should in particular address the fact that currently the regulatory framework treats the insurers as if they were short term traders, although their specificity is precisely that their underwrite long term liabilities matched with long term assets consistent with their Asset And Liabilities Management (ALM) policies.

Another important point to address in parallel, is the undue pressure on the insurers coming from the accounting standards and the mark to market obligations for the evaluation of their assets, be they long-term nature resulting from the fact that they will be sold according to the long-term maturity of their liabilities. In this respect the industry has insisted on the validity of the comments made by the European Financial Reporting Advisory Group (EFRAG) to the International Accounting Standards Board regarding the evolution of the IFRS 17 accounting standard.

There is thus a crucial opportunity to simplify and adjust the rules without losing of sight the need to protect appropriately policyholders.