Revising Solvency II: main policy priorities

Patrick Montagner

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Long-term measure: maintain heading and don't get swamped in complexification

While primarily leading to a major shift in the way insurers' solvency is assessed, Solvency II framework was also designed to take into account the specific features of long-term business such as life, pensions, or some specific non-life activities. For this purpose, Omnibus II directive superimposed a package of long-term guarantee (LTG) measures on the initial prudential framework, whose main objective was twofold: first to reduce the effect of short-term volatility of the markets and promote market value, and second to consider long-term financing needs of insurers. Today, LTG measures have proven their efficiency in practice, but simultaneously turned out to be quite heterogeneous in their use, impact and status. Therefore, they must be fine-tuned to rebalance prudential considerations, long-term business specifics, while avoiding the pitfall of complexification.

Equity measures, which were specifically developed to avoid penalizing long-term equity investment, are now too many and too varied, when sometimes not even used. They endeavor to bring an appropriate answer to each specific case, such as the DBER (duration-based equity risk sub-module) and the recent long-term equity investment portfolio (LTEIP), but since each asset class comes up with different criteria and specific rates, they lead to more complexity. Once more, when trying to accommodate all potential situations, we contributed to build a many-headed creature. Let's rationalize and have a wise move by rather focusing on the most relevant and sensible measures.

Regarding the volatility adjustment (VA), which efficiently corrects the volatility of own funds due to credit spreads changes, the focus should again be on the simplification and improvement of the existing options, rather than significantly changing its nature. While recognized as relevant and useful, the VA is currently on the table for discussion at European Insurance and Occupational Pensions Authority (EIOPA). However, it is unlikely that revamping significantly its design would increase its efficiency and robustness. For instance, adding the valuation of illiquid liabilities as an additional objective of the VA might go beyond the initial aim of this measure. We should rather make sure that its initial objectives are fulfilled, for instance ensuring that the VA country reflects more systematically and less abruptly national spreads.

The accounting framework and the implementation of IFRS are also major considerations to be taken, while we are still in a transition period. The future implementation of IFRS 17 is expected to provide a more accurate picture of the contractual obligations resulting >>>

>>> from long-term coverages. Indeed, discounting future cash flows and recognizing the expected profit margin over the coverage period is the way firms are monitoring the value of their business. However, the extreme complexity of the standard, including several models and various options, could lead to some difficulties for both preparers and investors. Moreover, from the point of view of the insurance supervisory authority, accounting must remain neutral and must not influence the way in which the insurer selects and prices its risks. We fear that the application of IFRS 17 as it currently stands could lead insurers to stop pooling certain risks or to design reassurance products, solely for accounting presentation purposes.

Finally, even if the actual framework meets most of its objectives, there is definitely room for improvement for both prudential and accounting regulations. While being ambitious and determined, we also need to be extremely careful in the context of the 2020 Solvency II review : what has been well conceived clearly needs to remain and that the initiatives to address the specifics of long-term business must be driven by simplification. Let's give priority to simplification and avoid the pitfall of complexification as this does not add value, but rather make things less accessible. ●

Dr. Frank Grund

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

Low interest rates are no reason to change the Solvency II regime

You do not have to be clairvoyant to see that insurers and supervisors will have to face the challenges posed by extremely low interest rates for a long time yet. Calls to change the supervisory regime in response to these challenges are getting louder, with suggestions that the ongoing Solvency II review process be used to introduce appropriate simplifications. My view is more differentiated. A one-size-fits-all approach is not the right solution here.

Our supervisory activities must not be dictated by financial circumstances, and we must guard against making imprudent and short-term changes to the supervisory regime according the prevailing economic situation – however much of a burden this situation may place on the industry. Insurers must hold sufficient own funds to cover all of the risks they are exposed to, regardless of any external conditions. This also includes the risks arising from an economic environment such as we have never seen before. It is the duty of supervisors to critically examine whether the regime is generally fit for purpose, even under these conditions. Any blind spots that are uncovered as part of this examination must be appropriately addressed.

One blind spot up to now has involved the consideration of negative interest rates in the standard formula: Solvency II does not currently allow for this. EIOPA has recognised this shortcoming and, within the scope of the SCR review, has put forward an appropriate proposal for remedying it. This proposal is still being fine-tuned by EIOPA and is yet to be implemented.

I see a considerable need for improvement as regards the appropriate treatment of life insurers' core business; this relates to the possibility, in future as in the past, of offering long-term guarantees to policyholders and beneficiaries in insurance contracts. The discussion here is too negative for my taste. I believe there is too little focus on the positive aspects for companies associated with obligations that need only be fulfilled at a much later point in time.

We therefore need mechanisms that are able to appropriately take account of the differences in risks between short and long-term investments of insurers. The keyword for me here is "appropriately". It is not the task of supervisors to promote economic development! We are responsible for clearly identifying how investment risks differ depending on their maturity. In my view, therefore, it is indispensable that the tools already included in the regime be analysed from this perspective – tools such as the volatility adjustment, which, in its current form, is well-intentioned but not very well executed. It combines elements that are intended to take account of the long-term nature of insurance undertakings' investments with elements that are intended to facilitate supervisory reactions in adverse market scenarios. Here we must draw a clear distinction. This is the subject of lively discussion within EIOPA. I am certain we will reach a good solution in the end. ●

Mireille Aubry

Head of Prudential Regulation Foresight and Standards, Covéa

The combination of key characteristics that underpin long-term investment

The "long-term" nature of insurance is shaped by cumulative characteristics. The first one is the duration of the commitments in the contracts binding the insurer to the insured and beneficiaries. This duration is, however, only one component of the total duration of the business. It is, secondly, necessary to take into account the ability to renew the in-force commitments, as well as the ability to maintain a relevant insurance offer (new business). Thirdly, the robustness or solvency of the insurer is an important element of long-term scoring because it initiates, strengthens, invalidates or depreciates the ability to sustain a long-term future. These long-term characteristics of insurance are the necessary starting point for long-term investment, but they are not sufficient.

Indeed, long-term investment has characteristics that give it a particular risk profile that is not sufficiently well understood by prudential and accounting regulations.

As regards prudential rules, long-term investment is a concern in Solvency 2 and its revisions.

It has quickly become apparent that provisions adopted in the name of financial stability, transparency and market confidence tended to favor short-term behavior and penalize long-term investments. In response, targeted measures have been adopted to correct what were perceived as undesirable effects of these reforms. However, in the end, these "patches" only have a limited scope. This needs to be addressed.

What is prudentially sound about a long-term investment policy? It is based on an assessment of long-term returns and risks and corresponds to a horizon that goes beyond an economic cycle to allow long-term investment to be counter-cyclical. The ability to manage in the long term is demonstrated by not having to sell or buy in contradiction with the performance objectives and appetite criteria expressed in the strategy. It should be noted that these characteristics allow several types of long-term strategies to be undertaken: passive "buy and hold" strategies, but also active ones. The latter are based on extremely thorough continuous monitoring of the micro and macroeconomic environment, as well as of market conditions and investees prospects to allow portfolio rebalancing.

Long-term management must be based on robust governance consistent with the long-term objectives set. The strategic framework validated by the AMSB must focus on this long-term objective and be based on sound risk management, effective control procedures and appropriate routine, as well as preventive and corrective management actions.

> *"As regards prudential rules, long-term investment is a concern in Solvency 2 and its revisions".*
>
> \- MIREILLE AUBRY

Long-term investment can be defined by the process by which the investor seeks optimized profitability over a long period of time. To use the OECD definition, long-term investment is a productive, patient and responsible investment. It is an investment that captures risk and illiquidity premiums where they are located and optimizes the diversification effects between asset classes and over time.

To sum up, prudential reporting must measure risks inclusive of the management and mitigation actions. As regards the accounting framework, it must allocate fairly the valuations between the result and the balance sheet. ●

Fausto Parente

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

Investing for the future: investing the right way

Insurers are used to playing the long game. Life insurance and pensions in particular demand a long-term perspective and it is this perspective that enables insurers to invest in assets for a long period. This brings benefits for governments, economies and citizens.

Solvency II has, without doubt, resulted in a stronger insurance industry and one in which capital is better aligned to the risk it runs. But, could more be done to better accommodate the long-term nature of the assets that have for so long been the mainstay of life insurance and pensions funds? The 2020 Solvency II review will look at the characteristics of insurance liabilities, investments of insurers, long-term guarantee measures, and market valuation of insurance liabilities.

The market is evolving and the European Insurance and Occupational Pensions Authority (EIOPA) will remain attentive to these developments, in particular regarding changes in business models, especially in life insurance, with a move towards contracts with lower >>>

>>> and more flexible guarantees and, in some countries, the significant increase of pure unit-linked products.

"Long-term investments are essential to foster economic growth, develop infrastructure and boost jobs".

\- FAUSTO PARENTE

While this is a natural management reaction to ensure long-term sustainability of the insurers commitments and optimise capital, it also increases the transfer of risks to policyholders, putting more pressure on conduct risks.

In this context, EIOPA is analysing the available evidence on the characteristics and risks of different long-term life insurance products, especially concerning the illiquidity characteristics of the liabilities and the ability of insurers to mitigate short-term volatility by holding assets throughout the duration of the commitments, even in times of market stress. This work will feed into the 2020 Solvency II review.

EIOPA already reports on a yearly basis on the use of the long-term guarantee measures that were introduced to ensure an appropriate treatment of insurance products that include long-term guarantees and the evidence collected from these exercises will also feed into the review.

Insurance plays an important role in Europe's economy and the insurance industry and consumers have both benefited from the risk-based regime that is Solvency II. It is right to review the regime so that it remains fit for purpose. However, the review will be an evolution rather than a revolution and the fundamentals of Solvency II will remain.

Long-term investments are essential to foster economic growth, develop infrastructure and boost jobs. Insurers should not be discouraged from investing in long-term assets or illiquid liabilities. However, any changes to Solvency II, no matter how minor, cannot be at the cost of the consumer.

Ensuring a resilient insurance industry is a priority for EIOPA and the 2020 Solvency II review is fundamental to achieving this objective. EIOPA's Opinion submitted to the European Commission, to be published in June 2020 will reinforce Solvency II as an effective tool to support a strong and stable insurance sector. ●

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