REVIEW OF THE SOLVENCY II LONG-TERM PACKAGE

1. Challenges to be addressed on the occasion of the upcoming review of Solvency II

Reviews were planned when the new framework for the prudential supervision of the insurance sector was finalised. EIOPA provided technical advice on the review of the Solvency II Delegated Regulation in October 2017 and in February 2018. EIOPA's review of the SCR standard formula is risk- and evidence-based and reflects the intensive engagement of all relevant stakeholders from the start and throughout the project. The amendments to the Regulation adopted by the Commission largely reflected EIOPA's technical advice. It is now up to the co-legislators do endorse the draft by the Commission. A more significant review is planned for 2020 covering different topics ranging from LTG measures to reporting and disclosure. There will be public consultations in the coming months on these different topics. By the end of this year, there will be a final public consultation on the draft Opinion, which will be published and submitted as final advice by June 2020 by EIOPA to the Commission.

1.1. Role for insurance regulation in increasing equity investment

With the recent revised calibration of the standard formula for debt/equity that the Commission has put forward, one can question whether the industry is ready to invest more in equity.

An industry representative suggested that with such topics there is no clear yes or no answer. Although their organisation is using an internal model, so from that perspective it has a slightly different scope, the restrictions around debt within the proposal are strong.

The revision is the first move to illustrate that the insurance industry has a role in investing in the economy. The review allows for a long-term perspective with customers. The change achieved on the shock will help. However, all of the restrictions will limit the impact of the shock. More is expected from the 2020 review, which will take the role of industry into account.

For a company, there are incentives to rely on debt, but that is not the best way to finance intangible investment, start-ups or SMEs. More incentives for equities should be created from the investor side. Focusing on fixed income is currently an issue.

A regulator emphasised the benefit Solvency II, leading to a better risk management in the industry, which is a great success. However, he is nervous to hear about 'incentives' and 'supervision' being brought together. There should only be incentives if they are risk-based, prudent and within the framework. The expected global standard (ICS) should rely on market-adjusted valuations. Consequently, provided regulation remains in these boundaries there can be talk regarding incentives.

An official shared the concern about the consistency with ICS as the global standard. There should first be envisaged a reduction of the existing disincentives for insurance companies, while the incentives should not come from the prudential model.

1.2. Valuable added value of the Solvency II framework but the pro cyclical effects of Solvency II have to be addressed

A speaker noted that a big increase in equity investment is not expected in the coming Quantitative Reporting Templates (QRT) at EIOPA and asked about the first period of application of Solvency II and what the impact of the package is on long-term guarantees (LTG).

An industry representative confirmed that the issues are not only on equity investment. It is recognised that the framework is based on a one-year shock, whereas insurers are investing long-term for customers. There is a need to find in the regulatory framework the right balance between the risks being taken and offering a good return to the customer, and the capital put in front of that.

There is a need to review the pro-cyclical effects of Solvency II. The Volatility Adjustment (VA) is a good measure and dynamic VA could be extended, even when not using a standard formula. An industry representative added that the volatility adjustment is where there are the opposite incentives. However, those incentives are based on an average industry portfolio, which is not applicable or adequate for a long-term investor. Changes in the 2020 review would make sense, because their organisation stops being a long-term investor and sees strong volatility in its solvency ratios, which will lead to pro-cyclical behaviour. More generally, what will happen in a shock should be looked at to avoid all insurers moving in the same direction.

A regulator noted that Solvency II has generally led to much better risk management in the industry. LTG is the main purpose of the review. The LTG measures have first enabled a smooth transition from Solvency I to Solvency II, especially for legacy books. Since the framework is market consistent, the need was to avoid pro-cyclical effects and to ensure that long-term guarantees remain available.

Equity investments have not declined due to Solvency II. The driver for equity investments is companies' risk-return expectations and not solvency capital charges. However, long-term investments and liabilities (or guarantees) are two sides of one coin that should be brought together in regulatory discussions.

On the macroprudential side, an industry representative suggested the system still has to be made less pro-cyclical and more crisis-proof. Global-Systemic Important Insurers was designated for 2013. A range of issues had to be implemented in consequence, especially recovery planning and liquidity risk management planning. What is right for a large insurer might not be right for smaller insurers, however it makes sense generally.

Resolution is slightly different, as it is up to the supervisors. For some banks in some markets, lawsuits are pending against some supervisors. That must be avoided in the insurance area. There is scepticism about capital add-ons. If they were needed, they should only be used as a last resort and would need to follow clear rules.

1.3. Beyond long-term guarantees, a long-term business model

An official noted on the long-term issues that there are successes with Solvency II, which gave companies and supervisors new tools for risk management. It is important to talk about a long-term business model and not only long-term guarantees. The prudential model needs to increase the soundness of companies and of the system, but it also needs regulators in the economy, in order to ensure that long-term guarantees are not an issue, and enable insurance companies to behave as long-term investors.

The long-term business model of insurance companies is not only to provide pension products or non-life responsible coverage. The general characteristics of the activities and liabilities are also important. Their general stability and the general characteristics of liquidity allow for projecting the future and investment in long term products.

The question is not only about long-term guarantees, but rather all of the characteristics of the activities in the business model. Certain assets have been penalised by introducing market value and the related short-term volatility, into the characteristics of the regulatory risk assessment model. Some corrections on fixed income have been introduced and there remain equities issues to deal with.

An industry expert stated that insurers should not be treated as short-term traders. There are implications on the accounting rules, as the risks borne by insurers are mostly not market risks. The consequences of excessive volatility on insurers' accounts are significant and out of proportion with their economic role. Solvency II is a risk-based system and has to be stable. Coming to the risk limits, a reinsurance system could stabilise notation or revaluation.

An industry representative noted that in 2016 it made sense to start with debt as a fundamental economic system. However, when looking at long-term investments, the diverse incentives were of concern. On one side, there is a strong incentive for progress with liability management, which is meaningful. It is subject to the liabilities held.

To address this there are some studies from OECD and figures from EIOPA, but there is an issue regarding the availability of data. Even the most optimistic, from EIOPA and beginning in 2011, shows relative stability of the location. When the values went up there was divestment of equities. This happened after a decade when, generally in Europe, the amount of equities in the balance sheet has already been reduced.

This situation is not satisfactory for regulators as it is not good for companies. It reduces the diversification of their balance sheets. Investment in equity should be linked to the characteristics of the equities, not the model or the capital put in.

For the economy, the regulator needs to tackle the impact. The balance sheet of insurance companies that invest in the capital market is a huge buffer. These companies are the best investors for the long-term, and far better than general policyholders. In the current regulatory context in many economies, there are more and more unit-linked products, so the risk is transferred from insurance undertakings to the general policyholder. It is doubtful that is beneficial for the economy, because it is pro-cyclical in most cases.

This is what was experienced at the end of 2018 when the markets went down, which froze the development of unit-linked. That happens every time the markets go down and is a problem for financing the economy. Currently the companies' level of debt has never been higher. What companies currently need is equity, and some local stabilising.

Changes were made on infrastructure investments, proposed by EIOPA and adopted by the European Commission. These are incentives in the right direction. Although there are many constraints for the new infrastructure asset class, the mere recognition of this asset class is a significant improvement in itself.

More recently, some equities are invested because the insurance company is able to keep them for the long-term. It is what is desired to be recognised in the regulatory model through the proposal on equity holdings for the standard formula. There will be assessment with the industries in Europe to see to what extent this is something that is useful and well calibrated.

2. Seeking a level playing field

An official stated that Solvency II is a major achievement in the harmonisation of rules, but the rules have to be applied in the same way throughout Europe. This is an issue of the level playing field and consumer protection.

The common implementation of the rules in Europe is a big issue for the next review. It can be dealt with globally by a Solvency II review, but the issue must be tackled in parallel. There is an issue with a level playing field between companies, but the question of consumer protection is even more urgent.

Some actors are using it to build schemes that are detrimental to insurees. There are also problems with any kind of insurance. It means one country could depend on the supervision in another. However, the markets are still national. There are a few schemes in which insurers go into one country to represent another country.

There are three things to do. First, the issue of supervision must be tackled. It is good to have the same rules, but they need to be implemented with the same quality. An insurance union needs to be tackled. That does not mean a single supervisor is needed, because there are still national markets, companies and products. But a standard is needed, where EIOPA can play a role.

There is also an issue of cooperation and information between supervisors when there is a specific risk in one country. It should be understood by the supervisor, which means reinforcing the role of the host country. Resolution is another big issue. Therefore, this issue has been put forward in the ESA's review to better foster coordination and guarantee an exchange of information, in particular in cross-border business. In the case of near failure, it is important to have some tools to prevent a real failure and all of the negative externalities. France created a kind of framework preventatively, but it is more meaningful if done across Europe.

The third issue is insurance guarantee schemes and having guarantee schemes everywhere to tackle failures. Even with the best supervision in the world, and resolution, there may still be failures. In the absence of a European scheme, it is important to have at least the same rules and have policyholders protected in the same way throughout Europe. The responsibility for that should be on the whole country.

A speaker queried how a level playing field could be assured in a single market without a single strong supervisor. A regulator suggested that things are going well with the recent framework and there is work at the EIOPA level to achieve convergence. The recent ESA review gives the right answer to the question.

3. Broader issues facing the insurance industry

3.1. Reinforcing insurance sector investment in sustainable and ESG assets and improving the predictability of carbon price

An industry expert explained that the needs for new investment and sustainable growth prospects are immense. Insurers should be the main investor in this field. There are many efforts to improve calibrations to account for a new class of risk, and the positive and negative externalities of certain investments. There is interesting work to define brown and green investments, but they are not always easy to distinguish.

The taxonomy is improving. Even if that is done, brown sectors may be penalised without green sectors being incentivised.

One of the central points of all of the objectives for sustainable growth, whether they are in climate, water and other sectors, and the evaluation of risk, is the price of carbon. Many projects depend on a certain predictability of the carbon price from a long-term perspective but the price of carbon is a political question and not purely a technical question.

Insurers need to be in a position to invest after improvements in Solvency II procedures. One possibility for quick results, alongside all of the efforts to improve calibrations or take into account risks from green investments, is to set up a reinsurance system. Some countries have experienced such a system, in which there have been natural catastrophes. One way to think about this is by having a working group on this question in the Commission. This method of co-reinsurance to stabilise the evaluations of green risks should be thought about seriously. It will allow the risks to be taken into account in the efforts being made to establish a long-term carbon price.

A tax on carbon is one way to finance. France has experienced the political price of imposing taxes with the Yellow-vest movement. There is a dependence on both national and global political decisions. The price of carbon can change according to the price of petroleum in the world and the economic cycle.

A regulator stated that nature cannot be saved with Solvency II, but the sustainability point is valid. There is a risk-based and a market-valuation system, and that is the framework to improve. However, supervisors, the industry and regulators should maintain their rules to have market valuations and be risk-based.

A supervisor added that ESG is also about risks. A risk basis is not ruled out from the system. Sometimes political influence is there anyway, as has been seen with equity recalibrations.

An official agrees with the regulator that it is not the role of the prudential model to deal with sustainability. That does not mean that insurance does not have to deal with it. There is a desire to reform the NatCat public reinsurance in France, so that it contributes more to prevention behaviour and the preparedness of companies and insurees on climate change. Long-term commitments should be fostered.

An industry representative noted that their organisation strongly endorsed ESG in its investment approach and from the underwriting side, but because of the lack of data, there is a challenge to having a green or brown risk factor within Solvency II. It is too early for the discussion and the industry is already moving in that direction.

3.2. The impacts of IFRS 9 and IFRS 17

Regarding investments, an industry representative noted that for their organisation Solvency II is a metric in every decision about how to invest. It does its own risk assessments, as required by the regulation, and how the Solvency II ratio will evolve under stress is one of the major metrics when going to the board to say how its assets will be invested. Solvency II is discussed a lot and there is good discussion about the review. Yet, IFRS 9 and IFRS 17 are significant for the industry. Accounting is not looked at , at the right level.

As bancassurance, IFRS 9 is already used, but has an overlay. Finally, the impact of IFRS 9 is removed from the P&L of the group. There had been a shock at the end of 2018. P&L would have normally been hugely impacted by the volatility of the markets were it not for the overlay. Some companies are not in insurance but are common companies and had some volatility. The board took the immediate decision to derisk those companies because the P&L volatility was far too high. With the same volatility in the P&L due to IFRS 9, the board would likely say exactly the same things about the assets. Parts of IFRS 9 will be compensated under IFRS 17 with the VFA, but for a lot of the non-life insurer with huge volatility IFRS 9 needs to change.

All of the valuations of assets used to go in OCI. When there was profit or loss, it went in the P&L. That is not allowed under IFRS 9 and there is a push to bring it back for insurance, given insurance's nature of being a long-term investor. That will have a major impact on how insurers invest.

With IFRS 17, there are many technical discussions and the decision-making process is difficult and the work is with the ECB rather than the Commission. How to bring forward some of the key topics about the nature of insurance, such as reinsurance granularity, is not well understood. There are some simulations about the impact of IFRS 17 and significant volatility is seen from the new accounting standard.

There is not enough attention given to those two metrics, which are having a major impact on the industry, which is why the EU institutions will be encouraged to be more involved in the IFRS 9 and IFRS 17 implementations, otherwise there will be a major change in the industry over the next few years.

An industry representative added that the ultimate goal is to introduce IFRS 9 and 17 at the same time. One idea is to introduce a discount for share prices for the insurance industry.

An official shared the industry representative's assessment of IFRS 9 and 17. If what is done on the accountability side of Solvency II is destroyed by inappropriate accounting standards, nothing will have been achieved.