REVISING SOLVENCY II: MAIN POLICY PRIORITIES

1. Need for change in Solvency II

The Solvency II directive has taken a very long time to be approved. In 2013 a long term package and a transition period were proposed, which have been questioned by market investors for some time. In the context of the 2020 review many questions have emerged about the fact that Solvency II has had to embed more than in the past, and that its main consequence could be a new set of complex, technical rules to better address how the regulation has had an effect on economies, specifically when talking about long term investment. A supervisor stated that the main task of a supervisor is to protect policyholders, however the regulation is interlinked with macroeconomic policies.

1.1. The low-for-long-era and challenges for insurers

Complexity is inherent to the insurance sector due to the duration of the liabilities, then the industry has to assess in which way the long term investment is correctly addressed by the prudential regulation.

Moreover, a supervisor stated that the low for long economic environment is a challenge for insurers, life insurance companies and pension funds as well as for supervisors.

In particular, a supervisor feels that it is currently a low (interest rates) era, but recently there has been talk of a negative era, which is different. It is thus of paramount importance that insurance undertakings should hold sufficient own funds to cover all their risks.

Indeed, the industry is now facing risks arising from the economic environment that have not been seen before. However, supervisory and supervisory activities should not be dictated by recent financial circumstances.

Indeed, negative interest rates are a fact of life and need to be dealt with in the system. The insurance system needs to take into account negative interest rates.

An industry representative struggled with the predictability of interest rates when reading research about the low for long scenario. Two years ago, the representative's company did an in-house study on interest rates in the 1960's, when Europe was coming out of the Second World War. Europe was heading for a crisis, with interest rates in the double digits. Conversely, now the whole idea of, 'It will stay as low as it is for a long period of time,' is a difficult one.

There are natural low points where people will not invest in negative interest rate securities. Companies will then put the money into a bank account, which might have a negative interest of 0.5%, or buy gold.

A supervisor feels that it is difficult to sync effectively. Indeed, while on the short-term, risk free interest rates (RFR) are decreasing, organisations have to assess their 30- or 40-year liabilities's solvency capital requirements (SCR); there the effect is sometimes very important. That was probably not thought about when the regulation was built, now the question is how to fix that.

Finally, instead of making short-term changes according to prevailing recent economic conditions the aim should be to keep the Solvency II regime fit for purpose, which is why the review process is ongoing. Yet, the prudential system should not be revolutionised, but rather tweaked to address possible blind spots. Any identified blind spots need to be corrected appropriately, such as the negative interest rate. The European Insurance and Occupational Pensions Authority (EIOPA) made a proposal for that, which is now being fine-tuned.

An industry representative stated that Omnibus II was an instrumental milestone in allowing the applicability of Solvency II and has provided a workable valuation of the liabilities in the prudential balance sheet with measures and adjustments to the risk rate curve. Some fine tuning could still be done to the volatility adjustment. Further work is needed in SCR regarding dynamic volatility adjustment in order to provide a continuum with the prudential balance sheet and amendements to the criteria for the long-term equity investment portfolio are required to ensure its applicability .

1.2. Adjusting Omnibus II, keeping in mind a systemic risk perspective

An industry representative believes that changes to the volatility adjustment would be important in order to stabilise the whole system, which would free up capital capacity for longer-term real-economy investment. There is a question of whether it is desirable to increase the link between banks and insurers even further when looking from a systemic risk perspective. If this last liquid point is extending forward it will have massive implications for the whole valuation question and for the solvency ratios of the sector. The only way the sector can react if it wants to hedge that exposure is by buying swaps and/or swaptions from banks. The supervisory committee might not be satisfied by the transfer of the risk to the banking system, but it is a possibility for the industry.

1.3 Solvency II needs maintenance

A supervisor believes however, that the system has to be maintained. Maintenance of the framework is key; some essential refinements have already been done to Solvency II, with a more significant review in 2020.

Last year EIOPA offered the Commission some advice on changing and strengthening the sub-module on the downward interest rate risk because of market evidence.

The industry is possibly entering an era which is not low-for-long; if it is a negative era then that will hopefully be temporary. The framework may need to be adjusted, but not on a day by day basis since, Solvency II works and there is evidence for that.

2. Possible necessary evolutions of the Long term Guarantee package

2.1. Further addressing volatility would improve the regulatory framework

However, beyond the low-for-long context, an industry representative feels that the prudential system needs to be further stabilised to better reflect the actual underlying risks in the business model of insurance companies. At the moment the system is still reacting fairly directly to volatility in financial markets encouraging procyclical behaviours as well as overstating potential losses of own funds in volatile environments.

When long-term liabilities are examined, which are largely illiquid, then insurance companies do not necessarily have to sell assets when they are at a low point because of capital market changes, and liabilities are there for 20 to 30 years. Attention should be drawn on the important role

played by the accumulations of own funds including free surplus, regarding the strengthening long-term stance and sustainability, and against volatility (avoidance of fire sales). This is notably the case in non-life undertakings and within the mutual sector where own funds can represent very large proportions of the liabilities of the balance sheet.

Changing the yield curve is the baseline for the valuation of liabilities and of the balance sheet. Adequate dynamic volatility adjustment should enable a company to adjust to its assumptions regarding future adverse scenarios. This makes sense, because the entire Solvency II framework is basically based on a future perspective.

If there was a more stable framework then there would be less risk from a solvency framework perspective, and companies could basically use these risk capacities that they free to further invest in real assets. Furthermore, if there is a system that adequately reflects the underlying risk and is reasonably stable, then adding on macroprudential measures, makes sense.

Conversely, if there is an unstable regulatory system whose risk assessment changes every month, ever suggesting that there is potentially systemic risk, then it would not actually reflect the business model and the real risks in insurance.

A supervisor, however, reminded the audience that there needs to be an evidence-based framework, and according to the evidence available, there is no reason to change the current framework. A supervisor explained that the idea is to make the long-term guarantee (LTG) measure cope with situations like long-term investment as well as the low interest rate level.

An annual report has been produced on the functioning of the long term guarantee (LTG) measures. Volatility adjustment is one of the areas that is being worked on, and there will be ideas, open questions and open options in the upcoming public consultation.

A consultation paper that will come out in the middle of October will provide a chance for the industry to comment. In addition, a holistic and accurate impact assessment will take place around March 2020, which will allow EIOPA to provide the Commission and the political authorities with an opinion in June.

2.2. Stabilising an appropriate definition of long-term nature of the insurance sector is still necessary

An industry representative noted that a clear understanding is needed of the features underpinning the long term nature of the business. There are tentative definitions to long term, but they are often too simplistic and are not comprehensive enough leading to distortions in the assessment of risks and potential losses of own funds.

Omnibus II has catered for improved long-term approaches to the valuations of fixed-income assets, though it still leaves room for improvement in order to achieve further realistic levels of the spread risk, which should require setting dynamic volatility adjustment mechanisms. Yet it has left aside of the long-term guarantees package, long-term equity investments strategies. However, in this respect the 2018 Solvency 2 Standard Formula review has taken the appropriate step towards an equity shock effectively reflective of long-term investment which are not submitted to forced sales. It is mainly very much a question regarding investing in listed equity, provided that listed equity challenge is about short term illiquidity.

Equity shares have always been a long-term investment vehicle with equity markets being among the most liquid markets, and providing essential accumulation of capital fostering sustainable growth and favouring thriving innovation. Even for non-life insurance companies, investments in equity shares is undertaken with long-term horizons despite the fact that most of the time they have short claim settlements inducing short durations of their technical provisions in the balance sheet all the more since future renewals are disregarded under the contract boundaries definition. This does not give the full long-term view of their business model because their business is being continuously renewed.

For example, although medical expense businesses is thought of as very short-term, (less than one year claim settlement), those companies and notably mutual ones, can have own funds that represent 75% of their liabilities and have a long-term investment stance on the basis of their own funds. That is completely overlooked by the prudential regulation. The more own funds and free surplus a company has, the more it is penalised, because the regulation considers the market risks without acknowledging that financial robustness and liquidity provided given their ability to decide what and when to sell assets.

Long-term investors are often associated with buy and hold behaviours. Buy and hold has very much to do with what has been catered for with Omnibus II. If a company holds a fixed income security until maturity then the market value is not representative of its risk; it is a temporary picture of an economic loss, but it is not a realised loss, and if the company holds it until maturity then the loss will not be realised.

However, an appropriate asset and liability management (ALM) is not just achieved by buy and hold approaches. Another type of ALM, at the other end of the spectrum, would be the active management of assets. It is much more demanding, but it is rewarding because companies can capture risk premium and liquidity premium where they are. With equity active management companies can leverage their ability to hold against an adverse cycle. It is an ability ex-ante not to sell at worst times, and ex-post to make the most of financial markets with counter cyclical behaviours.

Finally, the time horizon for investing long-term is indefinite. Rather, long-term investment is the financial strategy which is only accessible to an operator holding stable resources, which both allow and require an asset allocation able to generate an economic return over time. There needs to be something that reconciles the two specificities of the business model that insurance companies have.

A distinction is needed between liquidity issues and solvency issues. In addition, marking to market is not something insurers dispute for evaluating the assets but evaluating technical provisions without thorough examination of the consistency of the approach with the asset valuation dynamics and implications poses a problem and distorts the view of own funds and potential losses.

2.3. Developing equity investment

An industry representative does not think the industry is especially well placed to pick up on the negative interest rate issues, as these issues are largely driven by the monetary policy led by the central bank. From an insurance company perspective, the low economic environment is mainly about unlocking corporate investment and developing equity markets, which is something achievable.

In the wake of the financial crisis a focus on short-term regulatory approaches has been put in place. Risks have been measured with short-term horizons that have tended to pose a problem for long-term investors. Long-term investments have declined since the financial crisis. A report submitted to the European Parliament Intergroup on long term investment in November 2018 by the French Long-Term Investment Task Force shows that long-term investments had not found their

level before the crisis. Expressed as a percentage of GDP, 2% is still missing, which is around €4.5 trillion.

However, a supervisor stated that according to EIOPA data there has been no disaster, negativity or escape from long-term investment since Solvency II started. Investment in equity is quite stable, as previous investment from the insurance sector was not high before Solvency II. There is an evident difference in different member states in terms of the level of investment in equity, meaning the same framework does not necessarily lead to the same consequences in terms of disinvesting or investing.

An industry representative noted that the idea is not to start Solvency III; it is evolution, not revolution, and it is very important to have the volatility adjustment and the criteria for the long-term equity investment portfolio improved, provided that negative interest rates might be an additional reason to invest in equities.

However, a supervisor feels that the review of the framework should stay within the recent Solvency II regime. Much discussion could take place about whether the accounting regime and the market valuation are right or not, but that is not really the purpose of the Solvency II review. The Solvency II review should tackle some of the shortcomings within the existing framework.

There will be no long term investments if there is no appetite for insurers to enter any long term liabilities. Before discussing equity, it is important to think about whether the regime is robust enough to enable insurers to enter into any long-term liabilities.

2.4. The need for transitionals

A participant asked panellists if there is a need for transitionals, given that Europe is in a very difficult economic environment at the same time that it is trying to get a Solvency II review pack approved politically.

A supervisor feels that transitionals have worked very well up until now and should be kept in place. They are a matter of trust. Insurance companies should be able to trust inter-regulation. Everything that is being done should be fully assessed with a full impact assessment, taking the recent situation of companies into account as much as possible. A supervisor stated that the purpose of the transition is to facilitate a transition.

However, in a world with negative interest rates the question mark is how negative future interest rates could be. There should be a moment when the cost of keeping cash should enter in the next discussion on the risk free rate curve on Solvency II.