SOLVENCY II REVIEW

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Thinking long-term, through short and medium-term measures

The first lesson of the Covid-19 crisis in the insurance sector is its robustness and the strength and flexibility of the Solvency II supervisory framework. The current counter-cyclical mechanisms, including the so-called Volatility Adjustment measure, have proved to be useful to mitigate the impact of market volatility on the balance sheet of insurers. It has also enabled to avoid pro-cyclical behaviors, even if counter-cyclical instruments of Solvency II will have to be entirely assessed in light of the whole crisis. In addition, the low-for-longer economic environment has to be better taken into consideration in the Solvency II framework, and its risk-based approach, and the EIOPA answer to the Commission consultation has contributed to this debate.

For all that, the current crisis has also highlighted new or growing challenges for insurers, such as business interruption issues, to name but one. The consequent rise in insurers' reputational risk has brought to light the benefit of transparency and advice to policyholders: they are of utmost importance to ensure that there is no mismatch between expected and effective insurance coverages. Furthermore, due to the context of the pandemic and of climate-related risks, the need to address the protection gap issue has hopefully gained traction, especially when observing the heterogeneity in the level of protection across Europe.

Beyond the question of state-owned reinsurance schemes, which benefit to insured people in countries where they exist, it shows that it is important that insurers act more and more on risk prevention with clients, via their role of advice. Solvency II has met one of its objectives, namely fostering a fluid European market to improve the ability of insurers to offer policyholders all the products they need. It will be essential to pursue this trend.

Ensuring suitable, stable regulation conditions will be one of the main challenges in the coming months.

From this perspective, a simplified Solvency II framework should be an important goal to keep in mind, in order to levy undue barriers to the supply of innovative and needed products by insurers. Moreover, supervisory convergence and level playing field are also essential to ensure similar policyholders' protection, irrespective of the origin of insurers and the location of the insured person. European supervisors are actively working to enhance the quality of cross-border supervision and the protection of policyholders in such context; in this regard, the development of a harmonized insurance guarantee scheme framework throughout the EU would probably help to reduce the observed heterogeneity. The freedom to provide services only makes sense in the context of a harmonized legal and supervisory framework in the EU.

Simultaneously, given their business profile, conducive to long-term investments, European insurers have a decisive role to play ensuring sound and sustainable financing conditions for corporate, especially for small and medium-sized companies, to foster economic recovery. Long-term investment was already encouraged by subsequent Solvency II revision, and one of the aims of the current review is to go further and detect potential unjustified restrictions to economy financing, in particular, long-term investment in equities.

Fostering sustainable financing conditions by insurers is of utmost importance, as insurers and reinsurers are at the frontline of the climate change challenges, as risks takers and risks carriers. The impact of environmental risks should be monitored on their solvency position as well as on the assets and liabilities quality they carry. Insurers must integrate tools and processes in their system of governance to properly identify, assess, manage and monitor climate-related risks and their impact on their business model and financial exposures.

The upcoming review of Solvency 2 will thus integrate new requirements in this regard in pillar 2 of Solvency 2. The pandemic crisis also provided a striking illustration of transition risks, with oil-related asset prices dropping in 2020. This preview of the still-to-come adjustment to a low-carbon economy should act as a warning: appropriate regulatory measures in the pillar 1 to penalize riskier investments could now be considered.

Once these adjustments are made, it will also be important to stabilize the regulatory framework to foster long-term visibility and long-term thinking.

MARGARIDA CORRÊA DE AGUIAR

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Solvency II review: ensuring the regime remains fit for purpose

During the third quarter of 2021, the European Commission is expected to unveil its legislative proposals for the much-anticipated review of the Solvency II framework. The process for the review, provided for in the text of the Directive, started as early as 2019, with the European Insurance and Occupational Pensions Authority (EIOPA) conducting an in-depth and wide-ranging technical analysis at the request of the European Commission.

The package of legislative proposals is expected to complete the regulatory toolbox, by introducing macroprudential tools, recovery and resolution measures and insurance guarantee schemes. Furthermore, and although it is widely acknowledged that the framework is working well from a prudential perspective, the review will also attempt to ensure that the Solvency II regime remains fit for purpose, recognizing the current macroeconomic context.

One unavoidable issue that deserves urgent revision to ensure such recognition is the calibration of interest rate risk. The existing provisions do not capture the risk of falling interest rates when market values are already negative, which is unanimously regarded as a fatal flaw under the current ultra-low interest rate environment. In fact, such fall has been observed on multiple occasions, including, very recently, following the swift and decisive action of the European Central Bank in response to the outbreak of the COVID-19 pandemic crisis.

The required amendment will undoubtedly take its toll on the solvency position of the European insurance sector. Nonetheless, that should not preclude its inclusion in the overarching review, under penalty that the risk incurred by insurance undertakings remains underestimated, ultimately compromising policyholder protection and financial stability. The risk is already there, it is just not being adequately measured.

A phased-in approach, as proposed by EIOPA, potentially complemented with adequate safeguards in Pillar II and Pillar III, such as the consideration in ORSA and the disclosure of the solvency position without the recognition of the phasing-in, appears to be a suitable compromise way forward.

Compromise solutions should be sought without jeopardizing the fundamental principles of Solvency II.

Another feature of the regime requiring action to ensure efficient functioning and reflection of economic fundamentals, and for which the Portuguese Insurance and Pension Funds Supervisory Authority has been as outspoken advocate, is the enhancement of the design of the volatility adjustment (VA). This mechanism was introduced by the Omnibus II Directive to prevent pro-cyclical behaviour on financial markets and to mitigate the effect of exaggerations of bond spreads. The experience gained during the first years of application of Solvency II has, nonetheless, showcased some shortcomings in its design.

One of such deficiencies relate to the country-specific component of the VA, which is intended to mitigate the effects of a widening of spreads affecting only one or a few national markets, but not the majority of national markets that are invested in bonds denominated in the same currency. This is particularly relevant for the Member State of the euro area, especially for those more susceptible to market fragmentation.

It has been observed that the activation mechanism does not work as expected, producing a 'cliff edge effect' of the country-specific increase. Notably, in periods where the spreads of a single – or few - countries would fluctuate around the trigger point, rather than mitigating market volatility, the activation of the country component translates into a larger volatility of own funds. Hence, the introduction of a factor to ensure a gradual and smooth activation of the country component and of a relative threshold calibrated as to ensure that national specific crises are properly recognized is warranted.

The above-mentioned features are just two in a myriad of issues that will certainly be extensively discussed – and negotiated – between the European legislators following the presentation of the European Commission's proposals. During the discussions, transparency and the spirit of commitment must prevail, in the sight of European unity and public-good.

Compromise solutions should be sought to solve difficult political negotiations, without jeopardizing the fundamental principles of the Solvency II Directive implemented in 2016, which led Europe to the forefront of insurance prudential framework worldwide.

JUSTIN WRAY

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Maintaining stability of the EU insurance sector in times of uncertainty

Although financial markets have gradually stabilised after the initial sharp drop in asset prices triggered by the Covid-19 outbreak, the ongoing lockdowns in most European countries cause uncertainty and medium-term risks for the economies. In addition, potential cliff-edge effects could materialise once the fiscal measures supporting economies will fade out. Strains to demand that will reflect into insurers' underwriting and overall profitability will take some time to unfold in parallel with the deterioration of the macroeconomic environment in which a reduction of economic activity and disposable income is starting to become tangible.

The outlook for the insurance sector depends critically on the future development of the pandemic and on the resilience of the economic recovery. Capital buffers of insurers were solid in the end of 2019 and proved resilient at the time of the virus outbreak. It stands out that life undertakings are affected the most due to their higher sensitivity to risk-free interest rates that reached their all-time low levels in the end of last year. The prolonged period of ultra-low yields is further negatively affecting the profitability prospects of insurers' investment portfolios, due to reinvestment risk. In addition, the risk of deterioration of corporates' ratings could affect the market value of insurers' corporate bond holdings.

The outlook for the insurance sector depends critically on the future development of the pandemic and on the resilience of the economic recovery.

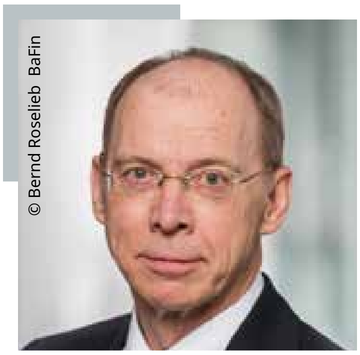
Nevertheless, European insurers have been able to withstand the dramatic situation as, in particular, the Solvency II regime helped them to better align capital to risk, build-up resilience and enhance their risk management practices. While risks surrounding the economic growth outlook remain high, they appear to have become less pronounced. EIOPA will assess the resilience of the sector to different recovery scenarios within the European Union-wide insurance stress test carried out this year.

In its Opinion on the Review of Solvency II, EIOPA proposes to broaden the prudential regime to incorporate the macroprudential perspective. The tools seek to enhance monitoring and add supervisory powers that might be useful to address the sources of system risk.

Examples are the power to define soft thresholds for action at market level if a certain exposure increases dramatically and/or reaches a significant level, the expansion of the prudent person principle and the use of ORSA to include the macroprudential perspective, the request of pre-emptive plans (such as recovery or resolution plans) or an enhanced liquidity risk monitoring.

In addition, EIOPA also proposes that supervisors should have the power to set a capital surcharge to address one or more entity, activity- or behaviour-based sources of systemic risk or, in exceptional circumstances, additional measures to reinforce the insurer's financial position (i.e. the possibility of restricting or suspending dividend or other payments to shareholders and the possibility of restricting the purchase of the insurer's own shares).

A strong and stable insurance sector benefits the whole of society. EIOPA will therefore continue its work to ensure the early identification of risks and vulnerabilities, so that the insurance sector can continue to play a vital role in Europe's post-Covid recovery.



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FRANK GRUND

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Macro risks are increasing the requirements for micro-prudential supervision

The impact of the coronavirus pandemic has reinforced the biggest challenge for insurance undertakings: the low interest rate environment. Moreover, this year the crisis could also have a negative impact on the ratings and quality of corporate loans, and put pressure on commercial property prices.

These macro risks result in increased requirements for micro-prudential supervision. For example, the low interest rates are posing a threat in particular to the business model of life insurers, because in the past these insurers often promised their customers interest rates which they are now finding difficult to generate on the capital market. However, BaFin does not leave it at that, but uses a proactive approach in its supervision. BaFin ensures that the guaranteed interest rate for new business remains at a level which life insurers can afford in view of their risk-bearing capacity and earnings power. Anything else would not be sustainable.

From a risk management perspective, there is no simple analytical procedure for determining the guaranteed interest rate. However, setting a guaranteed interest rate of 0.9% without further evaluation is not considered proper risk management. In Germany, the guaranteed interest rate refers to the savings portion of the premiums that remains after the portions that are earmarked for the acquisition and administrative costs and for insurance coverage have been deducted from the gross premium.

The level of the guaranteed interest rate is limited by the maximum technical interest rate for the calculation of the premium reserve, which is currently set at 0.9%. However, when determining their guaranteed interest rate, insurance undertakings should not apply the maximum threshold, but should set a rate that is significantly lower than 0.9%. I also fully support the lowering of the maximum technical interest rate by the legislature.

BaFin has developed tools for proactive supervision and is using them in a targeted manner during the pandemic.

As at 30 September each year, insurance undertakings must submit a projection to BaFin on the impact of certain capital market scenarios on their future performance. Our analysis of these projections is based on a dual approach. Firstly, undertakings are required to determine, on the basis of local GAAP, whether they can continue to fulfil the guarantees they have given to their policyholders in the future. Secondly, BaFin considers the solvency ratios under Solvency II: undertakings need to have a solvency ratio of more than 100% in order to remain active on the market and to write new business. The ability of undertakings to meet existing guarantee obligations is currently less of a concern to BaFin than their ability to write new business.

At the European level, Solvency II is the most important regulatory parameter - and this parameter is currently being adjusted: EIOPA's proposals for the review are acceptable to a degree, but I still see room for manoeuvre. For example, the proposed changes to the extrapolation of the risk-free interest rate term structure: if these changes were to come into force, they would result in a significant additional burden for German life insurers. I am still hoping that readjustments can be made here.

GORAZD ČIBEJ

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The Solvency II review: a "risky" business

Covid-19 has had a huge impact on the insurance industry: financial dislocation across investment classes increased exposure in certain lines of business, such as business interruption, and life and pension products with guarantees. However, the full impact of the pandemic is not yet entirely clear, and so far, it can be said that the EU insurance industry has weathered the pandemic storm rather well and that most EU insurers and reinsurers remain well-capitalized.

This is an important lesson for the Solvency II review: demonstrating that there is no reason to fundamentally change a regime that appears to work well, even in a crisis situation. However, this does not mean that Solvency II cannot be improved. The regulatory framework must be strengthened in order to ensure that the insurance industry is capable of meeting future challenges. The pandemic has shown that black swans may well appear on the horizon more frequently than predicted in existing models. The solvency framework must also reflect the changing economic climate.

The Solvency II review must proactively help insurers to reduce the insurance protection gap.

The insurance industry plays a critical role in the management of risk. In its capacity as a risk carrier and investor, it is in a unique position to understand the pricing of risks. In their risk assessment, insurers must be vigilant in an ever-changing environment of risk and keep abreast of new emerging risks. The regulatory framework must support insurers in better managing risk by rewarding good risk management, and also by avoiding unnecessary and too complex rules and procedures. More importance must be attached to risk prevention and risk mitigation.

Supervisors must assist insurers in their drive for better risk management. They can do so by increasing the frequency of supervisory reviews, by making analyses more granular, and by regular stress testing. Supervisors must also be aware that risks, such as those related to climate change, can have on financial stability. By assisting insurers in the identification, monitoring, and assessment of these risks and by contributing to the mitigation of these risks, supervisory authorities can help to protect policyholders and to ensure financial stability.

Although sustainability is not specifically part of the Solvency II review, as it was not included in the European Commission's call for evidence, the importance of the sustainability agenda is such that this issue must receive proper attention in the review.

Finally, the pandemic has shown that proper customer information is crucial to make the insurance market work efficiently. Policyholders need to know which risks are covered under insurance policies and why certain risks are excluded from coverage. The exclusion from coverage may not be such that new protection gaps are created or that already existing gaps are increased, and this should be clarified at the onset. It is important that the insurance industry fulfills its socio-economic role by reducing the many protection gaps that still remain, in areas such as pandemics, natural catastrophes, pensions, health care, etc. The Solvency II review must proactively help insurers to reduce the insurance protection gap.

If necessary, a public/private partnership should be built in order to deal with risks which the private sector cannot bear on its own.

AYLIN SOMERSAN COQUI

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The Solvency II Review should better reflect insurer's long-term business model

Solvency II is strongly supported by the insurance industry and the framework has proven its value since its implementation in 2016, including during the ongoing COVID-19 crisis. However, the framework is excessively conservative - if not the most conservative globally -and does not fully reflect the long-term insurance business model. Solvency II has a number of flaws to be addressed, which - if left unattended - cause an inaccurate reflection of the individual insurer's economic solvency position and reduce the sector's contribution to the economy.

The long-term insurance business model enables insurers to hold illiquid, long-term investments without the risk of forced selling, while using contractual asset cash flows to cover insurance liability payments. The value of insurance liabilities should thus be based on an interest rate term structure that is not subject to unwarranted volatility, in particular on the long end of the curve, where no reliable financial markets exist as a benchmark.

The existing Solvency II extrapolation method for risk free interest rates provides an approach that addresses the non-liquid part of the yield curve. EIOPA proposes a new extrapolation method that would add substantial complexity while increasing volatility and result in materially lower solvency ratios.

Solvency II has a number of flaws to be addressed, which if left unattended cause an inaccurate reflection of individual insurer's solvency position.

Long-term insurance products with guarantees would become economically unviable - thereby transferring market risk for old age provisioning to customers. In addition, the sector would be forced to increase the use of derivatives in hedging long-term liabilities, thereby increasing the macro-prudentially undesired nexus to the banking sector. Similarly, short-term fluctuations in credit spreads are hardly relevant in a long-term insurance context and should be removed from the regulatory solvency measurement. However, EIOPA's advice seems to reduce the effectiveness of the volatility adjustment, while rather, its general application ratio should be increased, and the risk correction should remain based on the fundamental spread.

Both, an overly volatile extrapolation method and an inefficient volatility adjustment have negative impacts on solvency ratios and are likely to force the industry into countermeasures such as substantial de-risking of asset portfolios. This would entail an exit from, rather than increased investment in real assets and cause higher sovereign bond allocations.

In turn, this tends to prolong the low interest rate environment, while at the same time reducing policyholder returns on long-term savings and pension products. Equally important, the divestment from real assets would particularly affect green investments like infrastructure thereby challenging the sector's support of the real economy in the transition to a carbon-neutral future.

In summary, the Solvency II review is an opportunity to fix selected flaws of Solvency II to better reflect the long-term business model and related risks in regulation - without reducing policyholder protection or macro-prudential stability. At the same time such enhancements would foster the sector's contribution to political priorities like the Green Deal and addressing the pension gap in Europe – an opportunity that should not be missed.

MIREILLE AUBRY

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Long-term business risk profiles differ from raw market downside fluctuations, their resilience should be plainly recognized

The Solvency II "2020" review should not be a missed opportunity to improve the framework and regulators should focus on the pressing need to render prudential regulation more fair to economic valuations of long term business models and their true risk exposures.

The resilience of long-term business models to short term financial movements stems from their stable resources that allow a long-term stance to investment choices and strategies. The stable resources are not uniquely sourced from the duration of insurance products based on the cash flows of their insurance guarantees. As important is the ability to pursue business as a going concern (renewals, future premiums, new clients). Own funds also contributor to the stability and length of resources. Their amount can even exceed the amount of the technical liabilities with a duration potentially infinite.

Against the backdrop of the stable resources of long-term business models, insurers put in place ALM policies and actions that seek performance over time while commanding to all possible vulnerabilities, the main one being the forced sale of assets with market losses. For that, ALM warrants adequate coverage of cash outflows with cash inflows including buffers to cover possible deviations. This is proved by the Solvency II quantitative data reported by insurers.

One year of inforce business cash outflows on average typically represent 8% of the total value of technical liabilities. This shows the limited exposure to the total sale of investments of a business model receiving premiums before paying any claims. This exposure is then further reduced due to ALM techniques by which a significant share of investments is fixed income with regular redemptions forming highly predictable cash inflows immune to changes in market values. Additionally, a significant share of the liabilities in the balance sheet is made of own funds of the greatest quality. These own funds have durations far beyond those of the insurance contracts liabilities and commensurate with the duration of the undertaking.

Consequently, risk exposure to short term movements is on average nil. With fixed-income average durations across sovereigns and corporate securities of 8 years, and considering a proportion of fixed income of 70% among the total investments, a typical average amount of highly predictable asset inflows immune to market fluctuations makes for almost 9% of the total value of the technical liabilities, and even 12% in the case of general asset portfolios making use of cash in-flows derived from assets backing own funds. These secured and immune to short term market movements cash inflows show their excess above cash outflows.

These features command a review of the Solvency II framework that makes the entire way towards offsetting spurious volatility and appreciating the low risk to short term market movements of long-term business models. A stronger focus to going concern is also required. Last, despite the current strong bias towards low for long interest rates, insurers cannot be left totally unprepared in their balance sheet against other pathways such as interest rates revivals. The risk-free interest rate curve needs to be sufficiently stable to be reflective of these cases.

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The challenges and the opportunities of the Solvency II 2020 review

The Solvency II regulatory regime is now entering into its 5th year of application but it has been under consideration and development since the early 2000s. Years of analysis and research have led to the creation of a prudential regime that is now regarded as a global benchmark.

Therefore, the fundamental pillars and metric of the regulation, such as the risk-based approach and the total balance sheet and market-consistent methodology, should not be questioned. However, the current economic environment, characterized by low-for-long interest rates and an unprecedented economic crisis, has further highlighted a number of issues related to the architecture and calibration of the Solvency II structure that deserve further analysis.

First, the recent financial markets turmoil has resulted in short-term excessive volatility of insurers' solvency positions. This is an "artificial" volatility as it does not correspond to a real change of the insurer's economic fundamentals, but rather to a flawed evaluation of insurance liabilities. As a matter of fact, insurance liabilities are not traded and priced on the financial markets but calculated according to a defined model.

The financial turmoil has resulted in short-term artificial volatility of insurers' solvency positions.

As a consequence, any market turbulence, while immediately reflected in the value of listed assets, is not as correctly replicated on the liability side of the balance sheet. This leads to an asset-liability divergence with a consequent impact on insurance companies' Own Funds. This problem has been partly mitigated by the Volatility Adjustment which should definitely be improved by focused corrections against some of its overly conservative and not fully economic aspects. Addressing the excessive volatility of solvency ratios is an objective to achieve independently of the occurrence of a crisis.

Second, the classic investment strategy of insurers - and life insurers in particular - is to invest in a portfolio of corporate bonds that is specifically designed to match expected payouts and expenses. This implies that assets are generally held to maturity, to replicate the average duration of the product's portfolio, and thus short-term fluctuations in the market prices of bonds are irrelevant. Against this structure, the capital requirements for corporate bonds are based on the assumption that insurers sell all their bonds portfolio at low prices in a situation of economic stress. This approach does not reflect the economic reality of the insurance business and should be somewhat compensated by taking into account the average holding period of the bonds portfolio.

Third, according to the EU legislator, insurance liabilities should reflect both the mean expected value of payments to policyholders (Best Estimate) and the uncertainty attached to it (Risk Margin), along with the transfer value approach. Hence, the Risk Margin should lead to a market value assessment of the insurance liabilities by reflecting the "cost" of uncertainty surrounding non-hedgeable risks. However, the Risk Margin prescribed calculation and calibration, first of all the "cost-of-capital" rate, is questionable and its revision is advocated, given the disproportionate impact that Risk Margin can have for certain categories of products, which does not seem to reflect their proper market value.

ALBAN
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Solvency II review: fostering insurers' long-term investment capacity

The Solvency 2 regulatory regime is now entering into its sixth year of application. Up to today, the robustness and consistency of this prudential regime have enabled European players to provide consumers with attractive products while preserving their financial strength even in times of crisis.

Yet, to be in a position to respond to the major challenges that lie ahead, foremost among them the Green Deal and the imperative economic recovery plan beyond the crisis, there are a number of elements of this prudential framework that are worth examining. Indeed, insurers' capacity to constitute the very core of long-term institutional investors should be fully mobilized for such objectives cannot be achieved only with public investments.

Insurers' capacity to invest over the long-term is based solely on their ability to offer long-term products. Long or very long-term reciprocal commitments between policyholders and insurers allow for potentially extremely long investment horizons, in a wide variety of assets, with buy and hold strategies that are specific to the insurance sector.

The Solvency II review should enable insurers to fully play their role without compromising the framework's overall balance.

Nevertheless, while this capacity to offer long-term products ought to be encouraged, some of EIOPA's technical proposals to the European Commission could make long-term products much more costly, with foreseeable consequences such as:

- Creating a potential protection gap in Europe with a shrinking offer of savings products for pensions or protection due to the increasing cost of capital, and this, in the European context of population ageing.
- An expected movement of divestments from risky asset classes matching inforce business to mitigate the lower solvency levels, at a time when we need investments in companies and in infrastructures to fund the economic recovery.

We should acknowledge that the current economic environment as well as the ambitions for the green transition call for adjustments to the framework that, if well-defined and kept to the essential, would enable insurers to fully play their role without compromising the framework's overall balance. To that end, we are convinced the following should be envisaged:

- Adjusting the standard formula to allow for negative interest, for it is the main macroeconomic change since the Solvency II regime's implementation;
- Reducing capital requirements by counterbalancing the introduction of negative rates with a lower risk margin; the vast majority of actors, including EIOPA, find the standing risk margin to be too conservative;
- Reducing the volatility of the solvency ratios as it leads to a higher capital charge notably for long-term products and long-term assets, which ultimately leads to higher costs for consumers.

In conclusion, AXA, like most actors in the market, maintains the current system works rather well and requires only a few well-targeted adjustments to unlock the investment capabilities the Public Authorities are calling for, while preserving a long-term product offering together with a high level of protection for policyholders.