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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.

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.