SOLVENCY II REVIEW

However, we should not be complacent. Solvency II needs to remain fit for purpose and to tackle the macroeconomic challenges of our times.

The principles of risk-sensitivity and market based valuation on which prudential rules rely, are essential to the success of Solvency II and should therefore be preserved.

Over the recent years, insurers have been facing an unprecedented protracted low – and sometimes even negative – interest rate environment. We have to acknowledge that Solvency II does not reflect this ‘new normal’. It is therefore legitimate to assess whether rules on capital requirements and on the valuation of insurers’ liabilities need to be updated in order to make them more risk-sensitive. This is a matter of credibility of the framework and of ensuring policyholder protection.

Moreover, insurance stakeholders have raised concerns about the volatility caused by the use of market valuation. When excessive short-term volatility is reflected in quantitative rules, it can indeed hinder long-term investments and the supply of long-term insurance products. Market volatility is expected to be mitigated by the so-called “long-term guarantee measures”. However, the developments following the Covid-19 outbreak showed that the measures sometimes have either too little or too much impact. Therefore, they should be reviewed so that they create relief only where insurers’ liabilities are truly “long-term”, and in such cases, the volatility mitigation should be more effective.

In addition, the Solvency II review cannot only be a technical response to new macroeconomic developments. It should also be a tool to support the Commission’s political priorities.

With trillions of assets under management, insurers can play a pivotal role in the financing of the ambitious targets set by the Commission for the economic recovery and the green transition.

As regards the economic recovery, businesses’ access to equity financing is one of the top priorities. This is needed to balance out the debt accumulation by European corporates, which increased during the pandemic. Equity investment is an area where insurers have probably been punching below their weight.

While Solvency II is not the main driver of insurers’ choice for investments, the framework may still provide disincentives to equity investments. The preferential prudential treatment for long-term equity investments introduced in 2019 did not yield the expected results, as the attached conditions proved to be too strict and complex. For this reason, in its new Action Plan on the Capital Markets Union, the Commission committed to improve prudential rules on equity investments.

As regards the green transition, we need to make sure that climate and environmental risks are better taken into account by insurers. We will also have to continue exploring, together with EIOPA, whether it is possible to differentiate prudential rules depending on the green or brown nature of investments, while remaining risk-based.

For our insurance industry to be well equipped to weather risks and committed to support a sustainable recovery, the cumulative impact of regulatory changes should remain balanced.

The Commission does not intend to overhaul Solvency II but to make it fit for purpose. Certain changes, notably on interest rates, will increase capital requirements. Such amendments are needed if we want to maintain a robust framework, which protects consumers and prevents financial stability risks. At the same time, we are mindful that significant overall increases in quantitative rules could have a disruptive effect on insurers’ solvency position, impact their ability to provide long-term and sustainable funding to the European economy, and affect their international competitiveness.

Therefore, the review of Solvency II will be a matter of finding the right balance. Balance between the need, on the one hand, to introduce improvements that are technically justified and supported by evidence, and the need, on the other, to recognise that insurers are already and overall well capitalised and that there are high political expectations that the sector ramps up its contribution to the economic recovery and the green transition.

Since 2016, Solvency II has brought major changes to prudential supervision in the Union, by providing a harmonised and sound prudential regime for insurance companies. Its first pillar set out an entirely new, risk-based framework for the measurement of risks. This was complemented by qualitative and transparency requirements under the second and third pillars. The reform aligned prudential supervision more closely with state-of-the-art risk management practices.

After five years of application, there is broad agreement that Solvency II has overall been working well. The Covid-19 crisis has been a real-life test. Without drawing conclusions too quickly, we can be largely reassured about Solvency II’s robustness and the industry’s ability to fare through these difficult times.
especially of sovereign bonds, create a risk of underperforming guaranteed returns on insurance contracts. COVID-19 has further accelerated the downward trend of sovereign bonds interest rates and has led to an increase in interest rates on corporate bonds, due to higher credit risk premiums. This has significantly increased the already high market risk for the insurance sector.

As a global pandemic, COVID-19 has also introduced other challenges, that critically influence the operational resilience of insurers. The operational difficulties resulting from lockdown measures taken by governments have forced insurers to innovate by moving to more digitalized operations and remote working, thereby increasing operational risk and cyber risk.

The effects of climate change, which have become apparent all over the world, have further strengthened the resolve of governments to move towards a more sustainable environment. The financial sector has an important role to play in this regard. Insurers will have to find ways to support sustainable development using their risk management, underwriting, and investment functions. They need to recognize the impact of climate change in their day-to-day operations and need to improve their internal scenario analyses and stress tests by incorporating environmental and socio-economic data. The availability of such data is essential in order to formulate clear climate action plans and take corresponding investment decisions.

The Solvency II review should adapt the regulatory regime to the new normal.

The Solvency II review should adapt the regulatory regime to the new normal and make those changes that are needed to improve the regime based upon the experience gathered since its introduction in 2016. One of the issues that must be addressed in this context is the imperfect functioning of the proportionality principle.

The Solvency II review should encourage more widespread use of the proportionality principle in the application of the valuation rules, in the calculation of the capital requirements in the standard formula, in the governance structure and in public disclosure and supervisory reporting. The regulatory framework should be clear and offer insurers legal certainty when they can apply a regime that is proportionate to the nature, scale and risks of their operations. Applying proportionate requirements should be automatic and not be subject to prior supervisory authorisation. At the same time, it should be clear when an “upgrade” to normal regular requirements is needed when an insurer engages in more risky operations.

These three new circumstances have a substantial impact on the business model of insurers. Low interest rates cause bigger problems to life insurers and insurers that are managing pension plans, while property and casualty insurers are more directly affected by climate change. All insurers must take account of the new normal, i.e. a world of market volatility and of increased digitalisation.

If one looks at Solvency II, it is clear that the current approach to interest rate risk in the standard formula underestimates the real interest rate risk in a low and negative yield environment. Furthermore, the evolution of market conditions also requires an adjustment of the long-term guarantee measures, particularly the extrapolation of interest rates and the volatility adjustment.
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Insurers stabilise the economic system

The key macro-economic challenges facing the insurance industry in the coming years are the low interest rate environment and climate change. Yield curves are not likely to increase substantially over the next years. This is why BaFin has once again set German life insurers a low interest rate scenario for the annual prognostic survey, and this will also form the basis for BaFin’s supervisory measures – for example in the assessment of whether transitional measures granted under Solvency II regarding compliance with the capital requirements for existing contracts of individual companies are still adequate.

Solvency II is risk-based and market-consistent, and therefore involves a certain degree of volatility. Insurers have so far been able to cope with this volatility, in part thanks to the volatility adjustment and the transitional measures. It is to be hoped that the Solvency II review has only a moderate impact here.

Additional capital requirements for insurers do not bring more capital into the system.

A risk-based system will never be able to address all of the micro- and macroeconomic developments in the years to come. But it will contribute to the stability of the insurance and financial sector – and thus to economic resilience. The insurance industry’s stabilising influence will be needed in another area, too: the transition towards a climate-neutral economy and society will not be possible without the insurance industry’s active contribution. In this context, we usually think of the investments insurance companies make.

Insurers and Pensionskassen are dependent on investment opportunities that generate high yields in the long term. It is therefore with good reason that European regulators have taken action in this area by introducing transparency and disclosure requirements.

More extensive changes, for example with regard to the capital requirements for green or brown assets, should only be placed on the agenda when there is sufficient and clear evidence for their suitability. Calibration based merely on political motives would threaten the credibility of the risk-based system.

The same is true for the core business of non-life insurers: property and liability risks for private, commercial and industry customers have already changed as a result of climate change. The damage recently caused by the flooding in Germany is a very clear example of this. Insurers are responding to this with better pricing models and adjustments to insurance terms and conditions. It is inconceivable that insurers could cover major risks without adjusting to the challenges posed by climate change.

Insurance companies will need no encouragement to embrace their role in managing the effects of climate change and in bringing about the required transformation in the real economy. They should demand sufficient preventive measures and thus work towards achieving climate change adaptation, both in industry and in society as a whole. Particularly in the industrial and commercial sector, insurers should also decide, with a view to reputational risks alongside strategic considerations, whether to make coverage dependent on the policyholders’ commitment towards achieving climate neutrality in their product range. The right approach here can be found in the supervisory expectations set out by BaFin and by EIOPA with regard to companies’ consideration of financial and reputational risks in their business organisation and in risk management. Insurers decide themselves which customers they insure and which investments they make. But investors, shareholders and rating agencies, alongside current and future customers and the insurers’ own employees, will all be watching to see whether and how insurers deal with the key issue of sustainability.
Making a success of the review of the Solvency II Directive is an objective shared widely among EU decision-makers. A refreshed rulebook will ensure that insurers and reinsurers can play a key role in the EU’s economic recovery following the COVID-19 pandemic while preserving the integrity and stability of the financial ecosystem in the EU.

With these twin objectives in mind, crucial features of the Solvency II framework may need a revision, as already outlined in the European Parliament’s own-initiative report on the Capital Markets Union, adopted with a large majority in October 2020. EIOPA’s Opinion on the review of Solvency II published in December 2020 constitutes a strong basis for the forthcoming legislative discussions.

In general, we should ensure that the overall level of capital requirements remains stable, while remaining cautious on the consequences of this approach. A zero sum game on capital requirements, where some European insurers would only win if others European insurers lose, would be detrimental for our strategic autonomy.

When examining crucial features of the Solvency II review in accordance with our twin objectives of economic recovery and integrity and stability of the financial ecosystem, four priorities emerge clearly.

1. Fostering long-term and sustainable investments

Freeing up the financing capacity of insurers and re-insurers can be a game changer in relation to the CMU. EIOPA has already made additional suggestions in relation to for long-term equity investments, building on recent changes to the Solvency II delegated act. However, more can and should be done to foster long-term investment in equity and private debt. Alternative approaches are to be explored to this end, including the use of internal models, a policy option supported by the European Parliament in its CMU own-initiative report. Similarly, channelling financing from the insurance sector towards sustainable projects will be key to the success of the European Green Deal.

2. Consolidating the consumer protection rulebook

Protecting insurance policyholders is a core objective of the Solvency II framework, and should remain at the heart of the future review. In recent years, consumers across the EU have faced challenging situations linked to cross-border claims. In this light, the review of the Solvency II Directive should aim to increase supervisory convergence and cooperation between home and host competent authorities, based on a stronger mandate set at regulatory level. Strong regulation and effective supervision should work hand in hand to deliver on the promise of a single market for insurance.

3. Adapting to the current economic situation

Insurers and re-insurers are facing the implications of the current exceptional economic situation with sometimes more acute pressure than other parts of the financial ecosystem. This is particularly the case with the persistence of the low-interest rate environment, a welcome and effective monetary policy response to weather the consequences of the pandemic on the economy. A better management of the perceived risks from this low-interest rate environment will also have to consider possible future rate increases. This forward-looking, future-proof approach will be at the core of the European Parliament’s analysis of EIOPA’s suggestions, in particular on the volatility adjustment, on the risk margin and on interest rate risk.

4. Simplifying

Further streamlining of reporting requirements, as envisaged by EIOPA, should be strongly supported, provided that reporting to the competent authorities and transparency towards policyholders is not unduly affected. Similarly, the European Parliament has called for a rapid phasing-out of national exemptions and for the reduction of ‘gold-plating’ in the national implementation of Solvency II. The due consideration to proportionality and to a risk-based approach should not be used as a means to weaken the European single rulebook and drive divergences across the European insurance landscape. Such simplification and harmonisation efforts are paramount to ensure the competitiveness of the European insurance sector in a context of fierce international competition.

Finally, the short-term focus on the review of Solvency II should also pave the way for a longer-term vision of the role of insurance and re-insurance in the fast-evolving economic context. EIOPA’s thought leadership on the coverage of pandemic risks and other non-damage business interruptions risks in insurance contracts should be followed up with concrete actions.

Mechanisms and incentives for better and fair coverage of such risks in insurance contracts are a key demand from the business community. To respond to this demand, the insurance sector can reinvent itself, not out of an instinct of self-preservation, but to continue to deliver on its mission to protect consumers and businesses.
Solvency II: a balanced review

In December 2020, the European Insurance and Occupational Pensions Authority (EIOPA) concluded its review of Solvency II. As we wait for the European Commission proposals in response to our Opinion, it is worth recappping the core elements of EIOPA’s Opinion.

Since its implementation, Solvency II has been a step change in how insurers approach their relationship to risk. Our approach was therefore one of evolution rather than revolution. Since its implementation, the insurance industry has better aligned capital to risk, uses a risk-based approach to assess and mitigate risks, which means that it can better price them. Insurers have also significantly strengthened their governance models and their risk management capacity.

The coronavirus pandemic underlined this view. The crisis has shown us that Solvency II proved effective in protecting the sector from market turmoil.

Nonetheless, for a regulation to remain effective, it must also remain fit for purpose. Therefore, we have to recognise that the situation today is much different to when Solvency II was conceived.

The realities we had to consider as part of our review included the ongoing low interest rate environment the impact this has had on insurers’ business models. We also had to consider climate change which, while not new, has taken on a more urgent dimension; and, of course, the COVID pandemic.

Starting with the low interest rate environment, given the massive intervention measures from central banks as a result of the pandemic, it is clear that the ‘low for long’ scenario will continue for a long time yet. The framework must therefore take account of the economic situation, notably with respect to the capital requirement for interest rate risk. The current interest rate requirement does not reflect the fall of interest rates experienced during the last years and ignores the existence of negative interest rates. Our Opinion therefore proposes changes to the treatment of interest rate risk, as well as to discount curves used by insurers, in particular regarding extrapolation.

Our Opinion does not change the fundamentals of the framework.

Insurers were able to withstand the shocks of the pandemic in part due to the work done during years following the implementation of Solvency II, entering the crisis with a robust capital position.

Looking beyond COVID, the insurance sector has an important role to play in supporting the economic recovery. Long-term investments – the type of investments favoured by insurers – are essential to foster economic growth, develop infrastructure and boost employment and should be encouraged.

In our Opinion, we have taken into account the nature of the long-term insurance business, creating conditions for more long-term investment. We are therefore proposing the changes to the volatility adjustment, the risk margin and equity risk. All of these adjustments should improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments.

Looking at about proportionality, which has always been an important element in Solvency II, there is certainly scope to increase its use. Our Opinion recommends a new process for applying and supervising the principle of proportionality. This includes clear risk-based quantitative criteria to identify low risk undertakings eligible for applying proportionality measures. These will capture not only the size but also the nature and complexity of the different risks and will provide legal certainty regarding the application of the proportionality principle. Undertakings complying with such criteria will be able, after a notification, to apply automatically a number of proportionality measures that – in the main – focus on governance and reporting.

Finally, we need to supplement the current micro prudential framework with the macroprudential perspective (including the introduction of specific tools and measures), as well as the need to develop a minimum harmonised recovery and resolution framework and achieve a minimum harmonisation in the field of insurance guarantee schemes.

Our Opinion does not change the fundamentals of the framework. Instead, we are proposing measures that we believe will keep the regime fit for purpose by the introduction of a balanced update of the regulatory framework, reflecting better the economic situation and completing the missing elements from the regulatory toolbox.

At the end of the day, Solvency II is here to protect the consumer. In our review, it was important for us not to lose sight of this fundamental objective. Our balanced approach ensures that policyholders will remain protected in these challenging times.
European economic activities. They assist their customers and by supporting management of risks by continuing to cause by this crisis and has done well. The insurers played their role in the crisis, but also to adapt its ability to manage the effects of yet another pandemic or climate related disasters.

For several years, the insurance sector has had to deal with an economic environment of low interest rates. It has also been facing major crises such as pandemics or climate related disasters. With the upcoming revision of its prudential framework, it is therefore legitimate to question its capacity to manage the effects of yet another crisis, but also to adapt its ability to finance structural projects namely the construction of a digital Europe or the transition to a European sustainable economy.

With regard to the resilience of insurers, we have been through an unprecedented crisis with the pandemic, which has generated technical risks, led to volatility in financial markets and weakened the solvency of clients. The intervention of public authorities was obviously essential to preserve the economy. However, the insurance sector has endeavored to rise to the difficulties caused by this crisis and has done well. The insurers played their role in the management of risks by continuing to assist their customers and by supporting European economic activities. They honored their contracts and often went beyond their contractual commitments, even going as far as providing direct assistance to the policyholders most in need.

To play this role, the solvency of the sector was a fundamental element. Moreover, it is obvious that the insurance business model, which aims to mutualize the various risks and to position itself as a long-term investor, is intrinsically built for absorbing shocks. So at a time when the prudential framework is being revised, we should avoid to disrupt a model that proved to be resilient even in a crisis situation.

In this regard, some of the proposals made by EIOPA may seem excessive. For example, even if we have to accept that a negative interest rate shock should be taken into account, it should not go too far and compromise the overall balance of the standard. Indeed, the possibility of investing in equities is counterintuitively closely related to the calibration of the interest rate shock. The direct effect of strengthening the interest rate shock would be to considerably increase the overall capital charge. Moreover, insurers would have an incentive to reduce their share of diversification since the projection of reduced interest flows would no longer sufficiently offset fluctuations in diversified assets. Such a regulatory development, would be particularly counterproductive as it is already difficult for investors to invest in equity due to the high capital charges in the current framework.

This volatility is likely to force the insurers into countermeasures such as substantial de-risking of asset portfolios and a massive reduction of their exposure to the equity market as early as 2022 to anticipate the end of the overlay. It is therefore urgent to adjust the accounting standards to translate the financial performance of investments under IFRS 9 in a more appropriate way.

In conclusion, we are advocating for a global strategy, taking into account prudential and accounting aspects, in order to remove the obstacles in equity financing for insurers who are by nature long-term institutional investors. Such enhancements would foster the insurance sector’s contribution to the political priorities of the European Union while maintaining its economic sovereignty.

On the contrary, given the business profile of insurers being conducive to long-term investments, improving the prudential treatment of long-term investments should be a priority to finance in particular the transition to a carbon-neutral future and digitalization of the European economy.

In this respect, some Member States have put forward a risk-based constructive solution that introduces a liquidity test to justify a reduction in capital charges and simplifies the framework for long-term investments. In addition, there is a political objective to support European companies in a context of strong international competition.

We are advocating for a global strategy, taking into account prudential and accounting aspects.
and their inherent and evergrowing market volatilities? Or are insurance undertakings’ exposures to market risks better depicted in accordance with the actual timing of the investments and divestments in accordance with insurance undertakings entity specific risk appetite, ALM, investments policies and management actions that forge the reality of the cash in- and outflows over different time horizons? What relevant information are market values really conveying about insurers exposures to market risks that is to say to their potential actual and probable future losses and profits? A major issue with financial inputs based on market prices is their potentially huge volatility not commensurate with the actual risk insurers are exposed to and not providing a complete information. The volatility of financial markets is primarily the result of uncertainty but also the result of the activity of market derivatives and their interest in volatility. Hence financial markets alone are not best placed to convey a complete and insightful information that can be used for true guidance and governance.

The above mentioned limitations inspired the Omnibus II Directive that has complemented Solvency II initial unbalanced framework. Omnibus II has been instrumental in rendering Solvency II applicable in the field of bond instruments and enabling its entry into force. Yet, and also because of the strong concerns about the repeated deferrals of the advent of the new solvency regime, equity instruments have not been under enough scrutiny to help patch the initial framework and sufficiently assess their associated risks in the context of long term business models and investment strategies.

Financial markets alone do not convey a complete information that can be used for true guidance.

We should value more adequately, and also treasure for macro-economic reasons, long term investment strategies in equity based on informed decisions, internal expertise and adequate market timing. This has been the purpose of the adoption in March 2019 by the Commission of an amendment to the Delegated Regulation of a new article (Article 171a) dealing with the treatment of long-term equity investment. Unfortunately, article 171a is hardly used in practice due to overly restrictive criteria. Insurers are awaiting the Solvency II review as a much needed opportunity to review article 171a criteria in order to widespread its application where long term horizons are the driving forces of the equity investment, which includes assets backing own funds. The results of a recent study by the Louis Bachelier institute show a marked effect of the regulatory constraints on insurers asset allocations. The analysis show that Solvency II constraints lead to a significant decrease in allocations to non-bond assets, for instance more than halved for equities (12% against 27%).

The true essence of insurance is the mutualisation and diversification of risks. A matter of great concern for markets, regulators and supervisors is the building up of systemic risk. Insurance could play a diversifying role. Herd behaviours based on spot prices are a major source of systemic risk in the financial markets. Diverse investments strategies as well as long term strategies are instrumental contributions to the reduction of volatility and hence the risk. Informed strategies based on tangible reality indicators not derived from pure market financial pricing is desperately needed. There is too much automated financial behaviours drifting away from tangible realities and conditions.

Qualifying market risks for insurers: long-term versus short-term prices

The main macro-economic challenges that have been faced by the insurance industry since the implementation of the Solvency II insurance framework are multi-fold with ever dropping interest rates, low levels of risk premia, abysmal sovereign debts and the ever increasing volatility of shaky financial markets. This is driven by multiple forces such as the new digital economy, climate change issues and the depletion of resources bringing a lot of change, disruptions, uncertainty and unknowns.

In this context, the main lessons that can be learned for the balance and calibration of capital requirements within Solvency II are the excessive bias to short term pricing and to bond investments. There is a lack of adequacy to the resilience of insurers business models and an exaggerated focus on liquidity. This is detrimental to performance and stability. To cut a long story short, the issue at the core of the debate is one of the adequate qualification of market risks for insurance. Are insurance undertakings’ exposures to market risks fully determined by market prices despite the “noise”, incompleteness and blurs carried by financial markets

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Insurance industry: a key player for the economic recovery after pandemic

We are living in the midst of a particular historical phase marked by extreme events on a global scale, such as a macroeconomic trend of low-for-long interest rates, a pandemic humanitarian and economic crisis and a global warming which is generating severe weather conditions like floods, heatwaves, droughts and storms.

In addition, the recent concerns about resurgent inflation completes the picture of an evolving macroeconomic context with possible new and unpredictable trends in the near future. However, despite this background, the European insurance industry has shown remarkable resilience, and the Solvency II framework has proven its robustness to a “real” stress test of global scale.

And in this very challenging context, there are, however, also positive signs that can open up new horizons and opportunities for growth if they are addressed in the right way in the years to come.

We must certainly appreciate that the European institutions reacted quite quickly and vigorously to the pandemic health/economic crisis and to the subsequent considerable increase in public and private debt, showing a cohesion that was unthinkable just a few years ago. The Commission’s “Next Generation EU” project, which implies the issuance of a substantial amount of common EU debt across global markets, represents an important step which could trigger an acceleration in the development of a more ambitious and integrated European budgetary policy.

Also the European Green Deal has the potential to play a key role not only in ensuring a recovery for economies in the short term but also in addressing long-term Environmental, Social and Governance threats, with a particular focus on climate change.

I believe that Investments in the real economy, infrastructure, private debt and private equity, long-term equity, green and sustainable assets, can boost yields...

But the main point it is worth emphasizing is that insurers are ready to play a key role in exploiting the opportunities that exist even in this adverse environment. In particular, we have repeatedly expressed our strong willingness to support the EU’s economic recovery and a sustainable path for Europe, but we need an appropriate prudential regime that does not penalize companies with excessive capital requirements and create opportunities to invest significantly in alternative asset classes.

I believe that Investments in the real economy, infrastructure, private debt and private equity, long-term equity, green and sustainable assets, can boost yields and can also contribute actively to the EU plans of recovery and green deal.

Over the years, the Solvency II regime has already been updated to meet these needs - e.g. infrastructure investments and high-quality private placements - but I do feel that further improvements are needed to make a framework that not only protects policyholders but also actively contributes to the benefit of the economy in order to face future global challenges.

With the current revision of the Solvency II framework, I believe that the discussion can increasingly develop around these issues. This is important also for our business model and strategic asset allocation: the use of “alternative” investments for insurance companies broadens the possibilities for building cutting-edge portfolios, making it possible to diversify into non-traditional instruments and supporting the EU’s climate and ESG commitments at the same time. In particular, this is true for green and sustainable assets: the new EU Green Bond Standards recently issued by the European Commission is an example of new investment alternatives in line with the EU green deal.

Hence, the next revision of Solvency II regime is crucial, not only to stimulate investments to non-traditional asset classes, but also to free-up excessive prudential capital. There is no doubt that some parameters are overestimated (I am thinking of the Risk Margin) or need some corrections (Volatility Adjustment) and that some assets are unduly penalized, such as the corporate bonds, which are usually held by companies until maturity to match their liabilities, while under Solvency II there is no recognition of this peculiarity. Freezing unnecessary capital is not economically sustainable and takes resources away from the full capacity of companies to support economic recovery at this difficult time, as well as risking severely penalizing the European industry in the international context.

Furthermore, we must be careful not to introduce new regulatory addendums like capital surcharge for systemic risk or new triggers for preventive measures and dividend controls. They could undermine the Solvency II approach and create pro-cyclical economic imbalances.

The risk-based and market-consistent principles of Solvency II are features that allow high levels of protection in different market situations: adding more capital buffers is unnecessary and would only be detrimental to our global competitiveness. In addition, regulatory uncertainty on our capacity to pay dividends should be absolutely avoided if we want to remain attractive in the financial markets arena.
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Solvency II: a regime fit for macro?

Since 2001, the year when many of us started work on “a regulatory project” called Solvency II, many things have changed. We have gone through at least three crises; we have seen technology blossom; we have witnessed social change; awareness about the need to do “not just something” around climate risk; progress regarding Gender agenda, or consideration regarding vulnerable clients, all steps in the right direction (a shame that we are not being so responsive to the Pensions time-bomb, where Insurance should play -if allowed- a key role). That Solvency II remains, is a testimony to a well-designed core framework; that it is being reviewed, to embed change, is a measure of its adaptability; that we still refer to it as Solvency II (Banking, allow me to be provocative, has seen Basel II, III, IV…) should be seen as well as a signal of recognition: it has worked well, and it remains a global reference for risk based regulation.

Whilst Solvency II was designed as a micro-prudential framework, we have discovered the hard way the need for it to be compatible with macro reality, including especially the challenges of negative interest rates. I recall, meeting Japanese regulators in 2008 to better understand the implications of low rates for the business, more as a notional, “what if?” type of exercise, rather than in expectation it would happen here in Europe, too. With hindsight, had we adopted Solvency II in the shape it had in 2009 - when it was published in the Official Journal- without introducing the so called Long Term Guarantee (LTG) package, a set of rules that deviate from the “pure” market consistent valuation of liabilities, many insurers would likely have been unduly put into liquidation, creating a financial stability problem. It is also fair to acknowledge that, had we continued in a Solvency I (non-risk sensitive) environment, even further problems would have resulted.

Let me conclude with two very personal reflections around Solvency II: firstly, one key element that is missing: taxation. With tax impacts sat around 20% of a typical P&L, if not this is not properly understood by regulators, it becomes a dangerous blind-spot. Secondly, if macro affects us all so much, why so much debate around providing regulators with macro tools?

Many things have changed these 20 years, yet one thing remains: Insurance is a business with a unique social dimension, as it takes risk from all of us, manages it and reduces it. Such a business activity demands what Solvency II brought in, namely a risk based regulatory framework to align the rules with the very nature of the activity being managed: Risk.

If we zoom into the current reality of negative rates, these have a massive impact in the profitability of the financial sector. What brought us here, namely the Big Crisis of 2008 and the need to avoid mass failures from banks, is no longer relevant; what should matter is how this situation is affecting insurers today, in terms of profitability and product offering, and how are they preparing for alternative scenarios, including one of “low for long” followed by a sharp increase of interest rates. Indeed, hope for good (a smooth constant increase of rates) but plan for worse (a sharp increase of rates).

A key lesson learned from 20 years of work on Solvency II is that perfection is the enemy of good.

Staying with the aforementioned negative rates reality, insurers must embed a “search for yield” approach to the asset side of their balance-sheet, taking more risk, in particular liquidity risk, to earn a spread that is currently distorted, inter alia due to QE -monetary policy, again- in terms of risk-return. Whilst insurers need to get even better at assessing underlying risks, there is an urgent requirement for regulators, too, to understand and accept more risk taking on the asset side.

On the liability side, we have seen a trend to put most -if not all- investment risk on policyholders, as offering guaranteed products in the current environment is risky and expensive. This is not in the best interest of policyholders, and Solvency II should ensure that, even in the current environment, insurers can take investment risk from their clients, and offer products with a sound value for money proposition. If this requires adapting existing rules such as the Matching Adjustment, so be it.

A key lesson learned from 20 years of work on Solvency II is that perfection is the enemy of good. The best example has surfaced under today’s negative rates environment: from a pure technical viewpoint, the current design of the extrapolation methodology, with a last liquid point at 20 years, is not backed by data, as proven inter alia by EIOPA. However, the design -technically flawed as it may be - served its purpose well, avoiding mass failures of insurers that would have, under a stricter application of Solvency II, been deemed insolvent.