SOLVENCY II REVIEW

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Reviewing Solvency II: keeping the regime fit for purpose

The Solvency II Directive came into effect in Europe on 1 January 2016 and was a true milestone, resulting in real progress in terms of risk management and the harmonisation of prudential standards in the European Economic Area. The insurance industry now uses a risk based approach to assess and mitigate risks. It also has better aligned capital to the risks it runs. Insurers have significantly strengthened their governance models and their risk management capacity. Solvency II is definitely an effective framework.

When the Solvency II Directive was introduced, revisions had already been planned to update the method of calculating capital requirements under the standard approach in 2018 and to assess the application of the long-term guarantees measures and measures on equity risks in 2020. At the request of the European Commission, the scope of EIOPA's Opinion on the 2020 review of Solvency II is wider than that provided by the Directive.

EIOPA' Opinion on the Solvency II review aims in particular at keeping the regime fit for purpose by introducing a balanced update of the regulatory framework and reflecting better the economic situation, while completing the regulatory toolbox.

From a prudential perspective EIOPA is of the view that overall the Solvency II framework has been working well and no fundamental changes are needed, but a number of amendments are required to ensure that the regulatory framework continues to be a well-functioning risk based regime. This is the reason why EIOPA has advised in 2020 an evolution to this prudential framework. More specifically on the aspects of the review of Solvency II that relate to quantitative requirements, EIOPA's Opinion proposes amendments on the long-term guarantee measures and measures on equity risk, technical provisions, Solvency Capital Requirement standard formula and Minimum Capital Requirement. The following does not intend to cover all quantitative aspects.

Solvency II is definitely an effective framework.

From the perspective of the economic situation, there are areas of concern, which the review should address. Subdued economic growth has led to extensive monetary easing, which was further intensified by the Covid-19 pandemic. Also, in the last two years, the euro swap curve moved to negative territory.

EIOPA's advice is that it is essential to recognise this economic picture in Solvency II. In its 2018 review of the Solvency Capital Requirement, EIOPA has proposed changes to the treatment of the interest rate risks to avoid that the capital held against it is underestimated. EIOPA considers that changes are necessary and suggests to reflect the low and negative rates recently experienced. In addition, EIOPA recommends changes to the interest rate curves used by insurers to value liabilities, especially in respect of the extrapolation. The changes to the extrapolation method increase market consistency and recognizes the changes that happened in the market since the current framework was developed in 2014.

Having said that, EIOPA also recognizes that, due to their long term liabilities, insurers are particularly well suited to long term investments. EIOPA's advice is that there can be a more favourable, prudent, treatment of insurers with long term liabilities. This is reflected in the EIOPA's suggestions of refinements to the volatility adjustment.

More favourable but prudent treatment is also recommended for the long-term equity investment, held against long term illiquid liabilities. EIOPA proposes to revise the eligibility criteria, to make them more prudentially sound, practicable and recognizing the long term character.

With respect to the risk margin, EIOPA proposes to introduce adjustments to account for the time dependency of risks. The effect of such change is a progressive reduction of the risk margin, which increases with the duration of the liabilities. Moreover, the volatility of the risk margin will be reduced through this change especially for long term liabilities.

The proposals of the European Commission published in October 2021 largely share EIOPA's approach and follow the objectives set in EIOPA's Opinion on the 2020 review of Solvency II.

Nevertheless, some important aspects have been modified and result in a reduction of the level of prudence with regard to policyholders. Prudence is an important element of Solvency II to avoid harmful situation for policyholders. EIOPA's advice recommended a more favourable but prudent treatment of illiquid liabilities as well as a balanced update overall. In EIOPA's view the removal of illiquidity considerations for the purpose of volatility adjustment calculations on the one hand and relaxations regarding the calibration on the risk margin and interest risk capital charge on the other, pose potential risks.

MARKUS FERBER

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Use insurance reform to trigger investments

The European framework for insurance regulation, Solvency II, has by and large worked very well. In fact, many consider Solvency II to be gold standard of insurance regulation. Any reform should therefore be an evolution rather than a revolution and should only look at those areas that actually need improvement.

One issue that certainly deserves some attention is the fact that Solvency II is calibrated very conservatively. In general, one wants insurance companies to be run conservatively, with a keen eye for appropriate risk management and in the best interest of policyholders. However, there can be too much of a good thing. After all, people buy insurance products not only to hedge risks, but also to invest for the future. Such prudent long-term investment has become even more important as public pension systems have come under strain over the past decades thus making private retirement planning increasingly important. People buying insurance investment products for the long term need to be able to earn a decent return though. For insurance companies to offer such a decent return, they need to be able to take calculated risks, such as investments in equities, which tend to outperform bonds over longer time horizons.

In an ultra-low-yield environment, solely investing in 30-year government bonds to match liabilities will simply not cut it anymore. Insurance regulation needs to acknowledge this new reality and allow for certain flexibility.

There is an even bigger role for insurance companies to play though: as a European Union we have set some very ambitious policy goals, for example in the area of digitalisation and moving towards a less carbon-intensive economic model. Achieving those policy objectives will require substantial investments that are measured in the hundred of billions. If we look at how stretched public budgets are following the Covid-19 crisis, it has to be abundantly clear that we will not be able to finance the digital transformation and the "Green Deal" with public funds alone. If we want to achieve our ambitious climate goals, private investment will be key.

The European Union has already recognised this by pushing for an ambitious sustainable finance agenda. Insurance companies could be exemplary long-term investors as they direct vast funds, have a long-term time horizon and predictable cash-flow needs. Hence, they are in a perfect position to invest in the long-term infrastructure projects that are needed in the context of the Green Deal. While this sounds good in theory, we also need to make sure that the prudential framework for insurers allows for such investments.

Insurance companies could be exemplary long-term investors.

Doing that will have a much bigger environmental impact than tweaking prudential rules to favour supposedly green investments. We should be very clear: insurance and reinsurance companies have very strong economic incentives to get their risk models precisely right and to assess long-term risks associated with climate change as accurately as possible. Therefore, there is little reason to believe that insurance and reinsurance companies are systematically mispricing climate risks. Accordingly, there is also little reason to introduce prudential measures to incentivise or disincentivise certain investments. Doing so would only decrease the overall risk sensitivity of the insurance regulation framework while at the same time misdirecting financial flows into supposedly green assets thus creating financial stability risks. To put it quite clearly: prudential regulation, for banks, insurance companies or other investment firms should not be misused to conduct environmental policies.

Lastly, the Solvency II review should also focus on another aspect that holds insurance companies back: unnecessary red tape and regulatory burdens, in particular for smaller companies. In the banking world, we have succeeded in introducing a more proportionate regime for smaller and less risky entities. While we cannot transpose those provisions one to one to the insurance world, the approach chosen in banking regulation can certainly serve as inspiration. A risk-sensitive prudential framework, that we strive for in insurance regulation, certainly requires that we avoid one-size-fits-all regulations and go for a risk-based regulatory approach instead.

If done right, the review of Solvency II can be a chance to recalibrate the European Union's insurance regulation framework to make insurance companies fit for the challenges of the future, allows them to invest in long-term and equity investments and enables clients to earn a reasonable long-term return.

FRANK GRUND

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Solvency II: Continuously improving an efficient risk-based framework

The last couple of years have confirmed that the risk- and principles based framework of Solvency II is able to provide the correct answers in an environment that gets more and more complex, both with respect to insurance products as well as the investment universe. The close interaction of qualitative and quantitative requirements under Solvency II allows for the necessary overarching consideration of insurance risks.

Quantitative solvency figures are typically more volatile than under Solvency I, in particular so for long-term insurance contract which are typical in the German life insurance market. Volatility though is not per se negative, as it may be economically justified and ensures risk sensitivity. If actual volatility is however accentuated by a framework such as Solvency II, this can be problematic. To ensure that life insurers are still able to offer long-term guarantee products to customers, the Long-Term Guarantee Measures were introduced into the system. These have proven to function well in the last couple of years, the volatility adjustment for example has proven to effectively mitigate spread-volatility during the first half of 2020 when the market spreads increased drastically as result of the COVID 19 pandemic. This helped to avoid pro-cyclical investment behavior these days.

The COVID 19 pandemic, which can be considered as the first real stress test of the framework, has shown that the risk-based Solvency II framework overall works well. In particular, increased risks and temporary losses observed especially at the beginning of the pandemic were well reflected in the solvency position of insurance undertakings. It could moreover be observed, that German insurers invested mainly anti-cyclically (e.g. they have bought additional BBB rated bonds which suffered higher market losses) while the majority of other market players has invested pro-cyclically. This has had a positive impact on financial stability.

As already outlined, the Solvency II framework allows to provide an overarching view on the soundness of EU undertakings, this is the basis for our supervisory considerations. During the investigations on the Solvency II review, EIOPA – as does BaFin - has stressed that the overall level of capital required under Solvency II – the level of prudence – is adequate. Changes to the framework proposed therefore intended to keep the balance and leave the level of capital unchanged. Continuous improvements to the quantitative requirements need to be risk- adequate though to ensure the framework staying fit for purpose.

Continuous improvements to the quantitative requirements need to be risk- adequate.

During the last couple of years obvious flaws were identified – which does not come unexpected for a system newly introduced, e.g. negative interest rates are currently not sufficiently reflected in the framework. A huge challenge for the future framework is its potential to reflect sustainability and climate change related risks. Risk-sensitivity also needs to be ensured in this respect, introducing flat 'green' and 'brown' adjustment factors is not the appropriate way to ascertain a risk-sensitive prudential framework

Now with first years of experience it was further possible to add more proportionality, e.g. simplifications concerning the capital requirement calculation in respect of immaterial risks. Since the start of Solvency II, being aware of the complexity of the framework and thus resulting efforts for undertakings, BaFin has paid particular attention to a proportionate implementation of the framework, e.g. with respect to exceptions from reporting or Pillar II requirements.

EIOPA also has a strong focus on proportionality. In 2020, the Advisory Committee on Proportionality (ACP) that supports EIOPA on proportionality issues was implemented. The insurance and occupational pensions stakeholders have observer status in the ACP and may submit proposals regarding the prioritization of topics from the EIOPA Work Program and the contents of the advice provided.

Based on the EIOPA Opinion, the draft proposal for the Solvency II Review introduces the category „low risk profile undertakings" (LRPU), setting out criteria for determining LRPU status and establishing explicitly how LRPU may implement certain Pillar II requirements. Only in exceptional cases may the supervisory authority keep an undertaking meeting all LRPU criteria from using certain of these LRPU specific minimum solutions. LRPU will also be exempted from the newly proposed assessment of climate change risk scenarios in the Own Risk and Solvency Assessment (ORSA).

In addition, BaFin appreciates that EIOPA intends to make the reporting requirements more proportionate for all undertakings by proposing template-specific thresholds for all non-core quantitative reporting templates.

JEAN-LAURENT GRANIER

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Solvency 2 : for a prudential framework aligned with a sustainable growth model

2022 will be a critical year for the European insurance industry. Many challenges will be on the agenda, one of which is the planned revision of the European prudential framework, Solvency II, with the effective start of the political negotiations. The fact that this revision occurs in an exceptional context of two years of pandemic crisis and now lasting pandemic situation strengthens the importance of this moment.

As Generali Group, we believe that the Solvency II framework has made a positive contribution to aligning capital with the risks incurred by the industry, strengthening governance models and risk management processes. The framework is now well established, has contributed to the stability of the insurance industry and has proven over the years that it is generally well functioning; this is why I believe that the fundamental pillars of the existing framework should be maintained.

However, a few steps should be taken to improve its efficiency and reduce volatility but, and most importantly, without further increasing the overall capital burden for the European industry.

The Solvency II framework has major socio-economic impacts both through the product offering to an ageing population and its stabilizing role of long-term investors. Therefore, the debate on the review should not be a pure technical exercise but should also be guided by a broader perspective. Indeed, insurers can greatly contribute to the key European projects such as the Capital Markets Union, the Green Deal and the sustainable agenda. Thus, the review of the prudential framework should help to support these initiatives without weakening the industry by adding excessive and unnecessary constraints.

There is a significant risk of contradiction between two realities: one on hand, the insurance industry is submitted to a regulatory framework (with capital requirements and undeniable phenomena of market volatility) and, on the other hand, is righteously asked to be supportive of the growth of the economy through investments in equities and infrastructure, in particular in the current context of recovery.

A well-calibrated revision should allow insurers' participation in the CMU and the Twin Transitions.

That is why the review should ensure that undue volatility is better mitigated to facilitate long term investments and that appropriate capital requirements are set to allow insurers' investments, both in standard and alternative asset classes such as sustainability and SMEs projects.

In particular, the strong fluctuations of the solvency ratios in the early stage of the recent Covid-19 crisis proved the inadequate functioning of the adjustment mechanism for volatility which should be made more effective in order to remove unintended artificial volatility in own funds, to avoid pro-cyclical investment behaviour and to limit forced sales of assets.

I also call upon policymakers to further investigate two categories of investments which are very satisfactory in a long-term-sustainable perspective; Sustainable Infrastructures and Green Bonds.

Currently the Solvency II framework recognises a set of qualifying criteria for infrastructure assets which allow using, in some specific cases, a more favourable capital charge. However, these criteria are restrictive and difficult to apply. Therefore, a more in-depth investigation of these criteria, in order to render them more accessible, including to entities using internal models, and more appealing to investors would attract more capital in these asset classes. This would help to mobilize investments across the EU in areas such as Sustainable Infrastructure which is one of the EU objectives.

The Solvency II review may also be a good opportunity to develop a specific treatment for Green Bond asset class, considering its different nature and risks compared to other types of bonds. Currently, Green Bonds are traded at a tighter yield compared to traditional bonds. To avoid undue penalization in the investment-decision process and to encourage more investments in Green Bonds, it would be relevant to develop a more appropriate risk-weight for this type of investment. Practically speaking, Generali Group has proposed to introduce to the framework a new category of long-term investments in Green Bonds, subject to lower, long-term stresses to the market value of bonds due to an increase in credit spreads, at specified conditions; compliance with the European taxonomy currently being defined on the EU Green Bond Standard, well identified investments and holding period, and capacity to avoid forced sales of each investment in green bonds for at least 10 years.

Generali Group is convinced that this initiative could be a significant contribution of the Solvency II framework towards sustainable growth.

RENAUD GUIDÉE

Chief Risk Officer - AXA Group & Chair - Net Zero Insurance Alliance (NZIA)

Solvency II review: targeted improvements to a balanced framework

The Solvency II (SII) directive has firmly established the European Union (EU) as having the most advanced and sophisticated regulatory framework for the insurance industry, leading other jurisdictions to draw inspiration from it and try to emulate it. The design of the current regime is the culmination of years of political negotiations, resulting in a balanced framework that provides for the highest standards of prudence to protect policyholders.

From that starting point, we believe the revision to the SII directive should pursue two objectives. First, leveraging the takeaways of the actual implementation, to derive targeted improvements where these are needed (for instance by further tackling the embedded residual volatility), and taking stock of the observed rate environment (while attention should be paid as well to the rate outlook, to avoid being one cycle late). Secondly, it provides a unique opportunity to put the European insurance industry in a position to contribute fully, with unlocked capabilities, to the EU's strategic ambitions, especially the Green agenda, the CMU and the EU recovery plan. Removing unwarranted complexity and arbitrary layers of prudence can help to sustain the highest standard of policyholders' protection, including by fostering an optimal capital allocation.

We see the European Commission's proposal on the valuation of insurance liabilities as pivotal if we are to meet both these goals. The proposal regarding the risk-free rate curve on the one hand and the risk margin on the other hand have their merits. Even though some proposed parameters (e.g., the alpha parameter on extrapolation) look overly conservative and should be modified to better reflect the economic reality, the former does incorporate the rate environment observed over the past few years, while the latter reduces a cause for excessive volatility in SII balance sheets.

However, our main concern lies with certain proposed amendments to the volatility adjuster (VA), to which we believe more consideration should be given so as to avoid too many changes that only result in complexity while actually reducing the VA's effectiveness.

Unique opportunity for the European insurance industry to contribute to the EU's strategic ambitions.

At AXA, we have always seen the VA as the right generic tool to address undue volatility in SII balance sheets and since 2016, this countercyclical measure has undoubtedly met its purpose. The fact that the VA is the same for all insurers is a key strength and ensures it does not become overly complex to calculate and supervise. Therefore, while we consider it can be further improved, we should rule out any change that would end up feeding procyclicality or adding complexity. In that sense we think that while the EC's proposal is going into the right direction, two elements are of concern:

- First, we consider the existing risk correction to be calibrated conservatively enough to reflect the impact of defaults and downgrades, and no evidence has been brought forward to prove otherwise. The proposed methodology would impair insurers' ability to reflect significant spread widening in valuing their long-term liabilities.
- Second, further consideration should be given to the proposed enhanced prudency principle for the Dynamic VA. In our opinion, that approach negates the conservativeness of investment policies and implicitly incentivizes undertakings with the safest asset mix to take more risks. This is the result of an unbalanced measure which significantly overshoots the issue that it aims to address, and which is at odds with the one-year 99.5th value-at-risk (VaR).

Separately, a major competitiveness issue could arise with the proposal on restricting dividends for undertakings not breaching their SCR. That measure (art. 144c) would undermine the integrity of SII and conflicts with the duties of the Board of Directors. Such measure will be seen by investors as questioning the robustness of SII, hence increase the cost of capital for providing protection to policyholders. It also does not ensure a consistent approach across the sector as insurers may still face divergent supervisory practices and actions. It would create a third level of capital requirements, in addition to MCR and SCR, which would unduly complexify the framework.

Putting the SII framework and its review in the global context, it will be important to preserve both the high standard SII has set and the competitiveness of EU insurers. The recent change in direction of the International Capital Standards (ICS) discussions has the potential to severely undermine both. Indeed, an ICS is meaningful only if it leads to a level playing field, based on the same fundamental principles that underpin SII: a market-consistent valuation and a capital requirement calibrated to a one-year 99.5th VaR, based on either a standard formula or an internal model. An ICS that would shift from that ambition of universality to a mere equivalence regime would undercut the high standards set by SII and undermine the competitiveness of the EU insurance industry.