Solvency II revision: major political challenges and options

1. The recent real-life stress test proved the robustness and efficiency of the brand-new EU insurance Solvency framework, which requires mainly evolution rather than revolution

A regulator noted that a review of Solvency II is ongoing. Solvency II has been in place for almost five years. Parts of Solvency II, including internal models and group supervision, are concepts that were not used prior to Solvency II. The Long-Term Guarantee Package (LTGP) should also be reviewed. The European Insurance and Occupational Pensions Authority (EIOPA) advice was to focus on evolution, not revolution, and ensuring fitness for purpose going forward. The current economic reality must be recognised: low interest rates, inflation, and the need to finance the green transition. Insurers are very long term investors. Some tools in the regulatory box on the macro side are also currently missing. EIOPA is content to see that overall the proposal of the Commission took on board this advice, although there are some concerns.

1.1 An appropriate risk measurement tool

An industry representative stated that their organisation believes that the framework is relevant in terms of risk assessment and risk measurement within companies. It has proven to be relevant in terms of empowering the management and governance bodies of the company to consider the risk dimension and the ability to face any unexpected situation. This framework contributed to the stability of the industry during the Covid crisis.

An industry representative stated that Solvency II has made the industry more resilient. The Covid crisis was a real-life, large-scale stress test, which the industry successfully passed. This is due to some key features of the framework, including the way the risk-free rate curve is designed, with a very stable extrapolation past the 20-year last liquid point. Overall, Solvency II is fulfilling its purpose. It is important to preserve the integrity of Solvency II.

1.2 Undue procyclicality is one area for progress

An industry representative stated that any framework will need improvement. Procyclicality and volatility are not captured well by the framework. In certain circumstances, the functioning of the adjustment mechanism is not adequate, which could provoke some unintended behaviours. When entering the Covid crisis in March 2020, facing the impact of own funds and solvency capital requirement (SCR) volatility, their organisation decided to sell the whole package of equities in its assets in property and casualty (P&C) in order to protect key performance indicators (KPI) and demonstrate stability. This was not intended by the regulation. This decision was taken to provide protection from unintended volatility. Procyclicality is not helping the industry.

An official noted that France holds the presidency of the Council of the EU. The Council agrees that focus should be on evolution rather than revolution, because the Solvency II framework is robust, globally well-functioning and efficient. This has been evident during the recent crisis, where insurers have maintained robust solvency ratios. There is a consensus that the fundamentals of the Solvency II framework should be retained, and attempts made, where needed, to make it more counter cyclical. There have been some procyclical effects during the crisis, so it should be made more counter-cyclical to ensure it is as robust as possible, while improving some supervisory aspects. This could be referred to as reinforcing investor protection, and cross-border aspects may be relevant here.

An industry representative commented that the ability to carry long-term investment should be taken into account for insurance. Unlike most players in the financial industry, insurers are able to have a long-term view with their balance sheet and make long-term investments. The current ability to take this specificity into account in the prudential framework is insufficient.

A regulator summarised that volatility, procyclicality and the ability to recognise long term were all mentioned.

An industry representative noted that some features of the framework prove to be volatile and procyclical, not least of which is the risk margin. This could lead to some counterintuitive and undesirable effects and behaviours by some undertakings and requires improvement.

1.3 Further clarification is needed on the policy regarding insurance undertakings' dividend payments in difficult times

With regard to the ability of insurance undertakings to pay dividends, an industry representative noted that there are already Pillars I, II and III with respective and complementary purposes, forming overall a comprehensive and consistent framework. In addition, there are corporate governance rules and responsibilities. Adding a separate criterion or process determining the ability to pay dividends even though the Solvency II position is robust would undermine the credibility and integrity of Solvency II and can be very detrimental to the long-term role of insurance undertakings.

A regulator commented that the approach to dividends should not be influenced too much by the banking sector. For BaFin it is clear that a prudent approach is necessary. Supervisors challenged companies on if they were able to pay dividends in the difficult situation. If companies were convincing, they were able to pay dividends. This was the European experience, which generally worked quite well.

A regulator stated that the absence of a level playing field with regard to dividends at the beginning of the Covid crisis was not helpful and must be avoided in future. The proposal in the review should provide very good safeguards.

1.4 The framework is still considered insufficiently proportional

A regulator stated that proportionality should be improved. There are some very reasonable proposals on this, including from EIOPA. Good progress has been made.

2. Consistency of the framework with the lasting EU economic and investment long-term challenges should be prioritised

With regard to volatility, a regulator commented that in March 2020 some companies felt forced to sell assets very quickly. But general observations suggest that life insurance companies did not do this so frequently and only under special circumstances. Therefore, in principle the volatility adjustment for life insurance companies worked relatively well. It is important to ensure that life insurers are able to take long term liabilities on board. The new framework of proposals is addressing this. The illiquidity of liabilities is a key driver there.

2.1 The green deal and the digital transition of the EU financing needs should attract the long-term savings held by the insurance sector

An official stated that the Covid crisis had been a real stress test where insurance undertakings proved their resilience. However, the prudential framework cannot be considered in isolation from the real world. The Council has put forward two big transversal priorities, the green deal and digital transition, which will require an additional €580 billion investment per year for the Union. A small amount of public finance could be used, but there must be a reliance on private financing. Fortunately, the European Union is the first jurisdiction in the world regarding the pot of savings. To match the ambitions and the supply and the demand, intermediation is needed. Insurance is probably the longest-term investor in Europe and will need to be relied on to achieve the necessary goals. The Commission's proposal includes some suggestions in this regard and is welcomed. The Council should aim to maintain or even reinforce the fundamentals of Solvency II, while enabling insurers to provide long-term financing for the twin transitions.

A regulator stated that we welcomes the proposal on proportionality. The proposals in the Solvency II review on dividends are also welcome. Europe's ambition for a green transition to a sustainable economy and the financing necessary for this must also be acknowledged. You [Organisations] need to look at what is at their disposal. Discussions should focus on the political and economic priorities, what the framework can do to support the financial landscape that meets the ambitions of the Capital Markets Union (CMU) and the transition.

An industry representative stated that the revision presents a great opportunity to align the political agenda and the big goals the regulation is aiming for. Europe needs massive investment to implement the green and digital transition. The ability to channel investment towards real assets is important. The European Commission's call for massive effort in this field is welcomed. We [Generali] has a pledge to invest in the real economy and finance the European Union economic recovery, as it has the ability to have long-term assets, which is insufficiently recognised at the present time.

2.2 The revision of the Solvency II framework represents a bedrock of the CMU

An official stated that the French presidency has linked Solvency II to the CMU. It is not only about the fore-text of the CMU, European Long-term Investment Fund (ELTIF), Alternative Investment Fund Managers (AIFM) and the Markets in Financial Instruments (MiFIR) review. Solvency II has real-world relevance. It is important to bring capital into capital markets. Insurers are long-term investors. The market needs people to buy things and to participate in the ecosystem. There will be a need for long term investment to finance the twin transitions, for example in infrastructure and in transforming the production system for corporates.

2.3 Various approaches to make the framework more consistent with the deep emerging financing needs, while preserving the risk sensitivity of the prudential framework, are under discussion

An official commented that risks are crucial for a successful transition. Regarding public and private finance, if what states can pay on behalf of their citizens, taxpayers and future generations is capped, the huge pot of savings that is in the European Union must be mobilised. Insurers are part of the solution. Insurers have abilities, knowledge and are able to offer flexibility. Whether the prudential framework should be changed in this respect is a concern. The overall capital requirement frameworks should not change. Ways to enable insurers to take more risk should be considered. There are proposals in the Commission text that are debated at level one that also have to be defined at level two. This is for the Commission to address. The French presidency aims to articulate both levels to provide clarity. If insurers want to be part of the solution to finance the transition, it probably cannot be business as usual as it has been for the past decade. Solvency II is part of CMU.

An industry representative stated that the review of Solvency will be very technical, with some very precise fine tuning, but concrete outcomes are needed. The aim should be to recognise the political objectives of the revision, develop a framework and align it to increase the incentive for investors to contribute. One industry representative's proposal is to create a specific new asset class for the long-term holding of green bonds. This is not greenwashing and would obey to strict, risk-based criteria. The asset class would be recognised as less risky than others, which would translate into a lower charge in capital...Private investors can contribute to the political objectives of the debate. If some of the precise outcomes were the rules of the region, it would be a real success.

A regulator noted the comments on embedding a political vision in a framework and bringing capital to the market. Insurers have capital, but this is what policy holders paid in.

A regulator commented that sustainability is currently the key problem for society to solve. The Solvency regime may not be the most efficient tool to solve these problems. The objective of CMU is too important to get it wrong. It is obvious that the industry is prepared to invest. Risk in a risk based Solvency system has to have a price, which is what the supervisors are advocating for. If the Solvency requirements are not risk based, the substance of the whole framework will be endangered, which will be detrimental for the customer. There is sufficient capital in the market. Supervisors did not want to increase capital requirements in the review. The proposal achieves this. It would be generally welcomed if there was evidence for less risk. EIOPA should be allowed to work on this and will provide professional advice. All supervisors would support a decrease in risk. Risk has to have a fair price. Changing this principle would lead to a revolution towards a different supervisory system.

2.4 The challenge for policymakers is to focus on removing any prudential requirement exceeding those imposed by an accurate risk assessment and to avoid undue parallels with the banking sector

An industry representative commented that the primary purpose of a prudential framework is to safeguard the long-term ability of insurance undertakings to live up to the commitments made to

their policy holders. This should not be compromised but does not have to come at the expense of insurers playing a role in the economy. It can be difficult to pursue two political objectives with one policy instrument, but it is not impossible. Focus should not be solely on prudential matters to the point that capital requirements are so stringent that the insurance industry becomes less attractive. This would jeopardise the ability to protect the policyholders. A positive feedback loop must be created where the large balance sheets of insurers are put to work for the economy.

The approach to asset allocation should not be too prescriptive. There are market cycles that may not be fully in sync with the normal political cycles when it comes to signing a framework, revising it and negotiating its implementation. For instance, the push on equity may be at the peak of the market and not look so appropriate a few years into the future with the benefit of hindsight. It is important to avoid fighting the last war. The pool of capital must be unlocked, but ability to discern where to channel it should not be overestimated. It should also be reminded that insurers are not banks. Regarding liquidity, there should not be a read-across from the banking industry to the insurance industry. We [the insurance industry] is not involved in any maturity transformation risk or interbank lending and is not an actor in the payment system. The CMU is crucial to provide a harmonised and consistent regulatory framework for the financial services industry as a whole but should also recognise the specificity of insurers and reinsurers.

3. Possible concrete outcomes and key performance indicators of an efficient review

3.1 A framework factoring in low-risk profile undertakings and requiring a reasonable level of information

A regulator stated that care must be taken for measuring the quality of the review with KPI´s. A A possible KPI could be whether distribution for insurance and life insurance profits for the customers are increasing. A sign of a good review would also be the usage of low risk profile undertakings (LRPU), which would show how much proportionality is really working.

An industry representative commented that information is currently too abundant and so there is a need to be more selective and focused. Reporting on transitory measures is meaningful. It is good to know the landing point therefore without the temporary buffer. On the other hand, there are permanent measures, such as the volatility adjustment (VA), for which there is no rationale for reporting with or without.

3.2 A longer-term view should unlock unnecessary regulatory capital and foster the effective competitiveness of EU insurance undertakings

Regarding unlocking capital, an industry representative noted that the political objective was set out by the European Commission when it released its proposal. A proposal to unlock €90 billion implies that the insurance industry is overcapitalised by €90 billion. However, the proposals did not amount to €90 billion, so work must be done to find solutions together.

A regulator stated that they agree that the €90 billion number should be reviewed.

An industry representative commented that it is very difficult to measure how much capital will be freed up and will allow additional investment. Some assessments are closer to €30 than €90 billion. Measurements impacts on the real economy must be considered, given insurers' direct investments in the real economy. If the aim is to increase the robustness of the framework, the real economy must be fed. Very often, the debate focuses on the standard formula. Regarding the internal model, the debate focuses on the way it is followed up, monitored by companies, and governed by supervisors. Improvements or changes implemented for standard formula do not translate into additional flexibility or improvement in the internal model… This aligns with the idea of avoiding any implementation that goes beyond the letter and the spirit of the European text and is very important if harmony is desired.

An official commented that there is a great deal of political talk also on the UK side. The European side does not appear to be pushing as hard as the UK government. It is not a competition regarding the degrees of capital requirements. The aim should be for neutrality overall. A framework regarding risk is preferred over a top-down approach. It is difficult to be purely science-based and rational in such a complex framework. If the political model is long term, a long-term, less procyclical and more countercyclical view is needed. How and at what time investments are made has an impact.

3.3 A framework combining risk sensitivity and green assets focus

An industry representative stated that the proposal for long-term green bonds does not ignore risk. The idea is to retain a risk-based approach. Currently, the framework does not discriminate sufficiently between asset classes. The financial industry has created many tools and asset classes, so the framework should be refined to be general enough and to capture the long-term nature of the risk and not confuse it with short-term volatility.

3.4 An ongoing monitoring of the robustness and trust in the insurance framework and sector is necessary in the context of the overall stability of the financial sector

An industry representative commented that trust in the risk management system overall and in the institutions must be increased. It is important to share ex ante what the objectives are, in order to measure whether they have been achieved. The objectives should go beyond not increasing the capital requirement. The robustness of the framework and the fact that it is shared, understood, applied, accepted and trusted everywhere could be a good KPI of the success of this review. An additional KPI to measure the success of the revision could be the international competitiveness of the European countries.

An official stated that the aim for five years' time should be robust, resilient insurers, as is paramount for financial stability. It is important that the framework remains resilient, and it should be risk based. Consumer protection improvement should be a focus. Cases that several member states have suffered demonstrate the issue and the need to announce cross border discussions among supervisors. The primary aim is to avoid failures, but the terms and consequences of failures are important. This will remain top priority for the Council. Insurers are only one part of financial stability. If markets do not function well, that is an issue for insurers. A suggested KPI is no drama, no failure if small, and with less consequences, and insurers being able to be there, according to the political language. The political

language should mean something, particularly regarding sustainable finance. It is good to have concrete examples. If an insurer can state that it financed a piece of green infrastructure, that may be better than financing a soccer stadium.

A regulator stated that they support the KPI of 'no drama, no failure'. The aim is for robustness that is shared, accepted, understood and used. In addition, the transition must be supported and good results provided for consumers.