GLOBAL AND SOLVENCY II INSURANCE FRAMEWORKS

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The dilemma of setting a global capital standard in insurance

On 9 October 2013 the IAIS announced its plan to develop a risk-based global insurance capital standard. We are now nearly at the end of a long journey that will lead to set this standard, the so-called ICS. The IAIS recently issued a final consultation paper on the ICS as PCR, i.e. as capital requirement according to the IAIS standards. The result of the consultation will feed into the finalization of the ICS, whose adoption is planned for December 2024.

In the light of the many challenges encountered in these 10 years of work, as well as of the strong scepticism that still accompanies the project, one could wonder whether we are moving in the right direction and even whether it is worthwhile to try and set a global capital standard.

The challenges to find an agreeable design and calibration of the standard are apparent, and understandably related to the different national supervisory approaches, legal backgrounds and market features. Scepticism mainly stems from the foreseeable difficulties to reach a sufficiently consistent implementation of the standard across different jurisdictions, also considering its minimum harmonization approach. In this perspective, the risk that the global standard could contribute to hide actual differences would become real. In other words, we could end up considering comparable what is actually different. In this case, the standard could even be an obstacle to effective supervision.

As an insurance supervisor, I think that despite the risks, challenges and scepticism, setting a global capital standard in insurance remains an essential and worthwhile objective.

Over time, the challenges will be outweighed by the benefits.

It is apparent that having a consistent metric to measure risks and capital would finally allow more effective prudential supervision of international groups. Clearly, this would facilitate supervisory cooperation. Macro-prudential considerations would be more effective, as a common metric to measure risks would allow for easier detection and management of systemic risk concentrations. A consistent approach towards capital requirements would also be a precondition to reach a consistent level of protection to policyholders and to ensure a level playing field for insurers.

At the same time, we should obviously be aware that setting the standard would be only the first step in achieving all these objectives. The next key step would require actual consistency in its implementation.

In general, it is safe to predict that consistency of the standard will not be sufficient when first implemented. The discretion left to national jurisdictions in transposing the standard as well as to national supervisors in interpreting many aspects of the standard will remain significant. In this regard, Europeans can easily draw the lessons from the first implementation of Solvency II, which - despite its maximum harmonization approach - still presents areas lacking genuine consistency.

In particular, the criteria to assess the comparability of the US Aggregation Method with the ICS will be outcome-based and, above all, mainly focussed on the comparability of the situations that trigger supervisory interventions. Even assuming that this type of comparability is achieved, it will not be sufficient to ensure a true level playing field between insurers in different conditions. Just to give an example: two companies might show the same ratio between capital requirements and available capital, but with a different amount in the numerator and in the denominator. This could trigger equivalent supervisory interventions but would not result in a level playing field.

In this context, I believe that it will be key to be stringent in recognizing relevant misalignments at national level, be aware of the consequences of these misalignments and be as transparent as possible in explaining them. At the same time, the IAIS and all parties involved, starting from the first implementation, should continue to follow a path towards progressively enhancing global convergence - which I dare to predict will be long and difficult.

Following this path, it will be crucial for the IAIS to work on its implementation assessment with quality and accuracy. Based on the assessment, the IAIS should then be able to provide application guidance and, if necessary, review the standard to limit excessive misalignments and promote convergence. In the meantime, it will be necessary to rely on sufficiently detailed and comprehensive disclosure of the solvency calculation, in order to avoid the obfuscation of differences and to allow the proper interpretation of solvency indicators by supervisors, insurers, consumers and all other users. The role of national supervisors will be essential in this respect.

All in all, it is true that a genuine global capital standard is still a long way ahead, but we are marching in the right direction and it is worthwhile to keep momentum. Over time, the challenges will be outweighed by the benefits.

VICKY SAPORTA
Chair of the Executive Committee - International Association of Insurance Supervisors (IAIS)

Finalising the ICS global capital standard for international insurance groups

Many journeys to Santiago de Compostela are long and winding and undertaken by individuals whole-heartedly devoted to reaching a conclusion, bolstered by a great deal of faith. So too has been the journey to finalisation of the Insurance Capital Standard (ICS).

Over a decade ago, the International Association of Insurance Supervisors (IAIS) embarked on its journey to develop the global solvency standard for internationally active insurance groups (IAIGs). This journey is now in its final mile. Over the summer, we have been consulting on the final standard. This will be adopted at the end of next year, taking on board comments from this consultation. With the adoption of the ICS we will have a global minimum solvency standard akin to that developed by our colleagues at the Basel Committee.

At the core of our role as a global standard setter is a commitment to supporting the development and maintenance of fair, safe and stable insurance markets for the benefit and protection of policyholders and contributing to global financial stability. The ICS supports this by providing a comparable solvency measure across jurisdictions, promoting sound risk management and minimising undesirable pro-cyclical behaviour while balancing risk sensitivity and simplicity. Having already adopted the qualitative element of our common framework for the supervision of IAIGs (or ComFrame) in 2019, finalisation of the quantitative element (namely the ICS) next year means that ComFrame will then provide a complete framework that establishes global minimum supervisory standards for the effective group-wide supervision of IAIGs.

We have designed the ICS to provide a consolidated minimum group-wide standard for IAIGs, allowing for a globally comparable risk-based measure of capital adequacy. The standard addresses all material risks of IAIGs, targeting a 99.5% Value-at-Risk over a one-year horizon. In essence, the ICS will provide a common language for cross-border discussions on insurance group solvency in a world in which we face many common and interconnected global risks, while also respecting the differences of our insurance markets.

A robust global standard which will support a resilient global insurance sector.

Thanks to the extensive data gathering and analysis undertaken to develop the standard, plus the current five-year ICS monitoring period (2020-2024), the ICS is one of the most meticulously observed, consulted upon and empirically driven international financial standards. The monitoring period has provided a period of stability in the design of the ICS, to assess its performance over the business cycle. Experience has shown us that the ICS performed well, with year over year comparisons producing consistent results, even under the stressed market conditions we have experienced because of the global pandemic.

We have been using this rich data set throughout the monitoring period to learn lessons and make adjustments as necessary to the design of the final standard. We have benefited from the active participation of insurance groups, representing a third of the worldwide life business and a quarter of non-life insurance business, providing both data and technical input during the monitoring period. Discussions at their colleges of supervisors have also provided valuable feedback on the ICS's performance. Additionally, we have conducted numerous workshops with volunteer groups and supervisors across the globe.

IAIS members are committed to the implementation of IAIS standards. Some members, for instance the European Union, Japan and UK, have already announced their intention to have a consistent implementation of ICS in their regulatory regimes. In parallel, the United States is developing an Aggregation Method to a group capital calculation, which, if deemed comparable, will serve as an outcome-equivalent approach for implementation of the ICS as a prescribed capital requirement. Earlier this year, we published the final criteria that will be used to assess whether the Aggregation Method will provide comparable outcomes to the ICS. While distinct from the ICS, our consensus on the criteria and robust technical process for the Aggregation Method comparability assessment will ensure the credibility of a truly global capital standard and comparable outcomes.

Following the adoption of the final ICS next year, the IAIS will employ a structured and robust approach to assess its implementation across jurisdictions. The exact timing of implementation assessment has not yet been determined, noting that transitional periods for implementation are common where requisite laws and/or regulations must be adopted by relevant jurisdictions.

We will end next year with a robust global standard, which will support a resilient global insurance sector, and is testament to the significant journey we embarked on more than a decade ago.

MARTIN LANDAIS
Director, Insurance Division - DG Treasury - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

Let's bring to a close the good work on Solvency 2

The revision of the Solvency 2 directive, which trialogue is about to begin, brings up significant political issues that are relevant not only for the insurance sector but also for the European economy and sovereignty as a whole. As we are on the verge of success to develop a safer, more efficient and competitive insurance sector across Europe, we need to be wary not to lose the substance by grasping at the shadow of a standard which would be only one by the name.

The Solvency 2 review will empower insurers to play a more significant role in financing European growth while ensuring policyholders' confidence in the single market's ability to protect them.

First, the review aims to facilitate insurance companies' active participation as long-term investors in the economy. Due to the long-term nature of their business, insurers should take a more prominent role in the CMU. This is why France, in collaboration with its partners, seeks to go beyond EIOPA's 2019 proposals regarding the relaxation of the Long-Term Equity Investment regime. Some progress was already made, namely at the European Parliament level, but the negotiations on the delegated regulation will play a crucial role in this regard.

Second, the review will enhance cross-border activities' supervision. This involves better coordination and cooperation among national authorities. While supervision remains a national responsibility, increased collaboration between supervisors is necessary as we deepen the single market.

Third, the review will enhance the countercyclical aspects of the framework, notably through the volatility adjustment, which is a very powerful counter-cyclical tool. The introduction of macroprudential instruments will also contribute to increasing financial stability, especially in a context of economic and financial turbulences such as the one we are currently navigating through.

The review will also improve the insurance sector's consideration of climate risk.

The current compromise includes provisions addressing the impact of insurers on biodiversity and the implementation of new European climate stress tests. Additionally, it mandates insurers to develop specific plans detailing their exposure to ESG risks, especially transition risk, as well as the actions they will take in the short, medium, and long term to mitigate these risks effectively.

The review will empower insurers to play a more significant role in financing European economy.

Finally, the review is on track to foster the development and competitiveness of the insurance market.

First, the review should not increase capital requirements. The pandemic has demonstrated that current capital requirements are sufficient to ensure the sector's resilience. Overall, the compromise text of the reviewed directive does not create any additional requirements compared with the existing text.

Second, the review aims to simplify prudential rules. For the least risky companies, prudential rules will be alleviated. The automaticity of the regime for these companies relies on a comprehensive set of objective criteria.

Last but not least, the competitiveness of our insurance industry is at stake in this review. That is why the notion of international level playing field was introduced in the recitals by the Council's compromise, to make it clear that we are not discussing European prudential rules from our Ivory tower. Of course, we must avoid a race to the bottom, and ensure that the level of prudence is adequate, but we should be mindful of the global context, and by this, I mean both the discussions on an international capital standard, and the review plans of the United-Kingdom.

Indeed, we have to make sure that the ongoing discussions about the International Capital Standard (ICS) do not undermine these endeavors.

The ICS is being developed with the relevant purpose of establishing a common approach applicable to internationally active insurance Groups. Efforts are underway within the International Association of Insurance Supervisors to accomplish this goal by the end of 2025. It is worth noting that the standard ICS shares several similarities with the quantitative aspect of Solvency 2, thanks to the joint efforts of the Commission, EIOPA and national supervisory authorities.

However, the standard ICS is not the cornerstone of this exercise. On March 9, 2023, the IAIS released comparability criteria, which raised significant reservations, notably from France, for being too blurry. Currently, the design of the capital requirement has been stabilized, but the issue of comparability between national methods and the ICS remains unresolved.

In this regard, the question of equivalence is pivotal. We should be careful that it does not undermine the level playing field principle, and thus all the good work done on the Solvency 2 review. We, Europeans, will need to be very cautious to safeguard an even, competitive and fair insurance market.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Final boarding call for the ICS

With an expected time for the adoption by the International Association of Insurance Supervisors (IAIS) by end-2024, now is the final boarding call for shaping the international Insurance Capital Standard (ICS). In these last stages of development of the ICS, EIOPA remains fully engaged and calls on all EU stakeholders to engage as well. Since the beginning, EIOPA has aimed for a minimum global capital standard that reflects the main features of the Solvency II framework, enabling Solvency II to become a practical implementation of the ICS.

In place since 2016, Solvency II introduced a forward-looking risk-based approach to assess and mitigate risk in the EU insurance sector. This framework has proven to work well over the years, strengthening the sector's resilience to weather financial, pandemic, and geopolitical turbulences.

In its advice of 2020, EIOPA supported a gradual review of Solvency II as an important element of good regulation and aiming at keeping the framework fit for purpose. The review should be evolutionary and balanced, to keep the current level of protection of policyholders. EIOPA's recommendations for the review included improvements to appropriately cope with changing macroeconomic environments, in particular for insurance products with long-term guarantees. We recommended completing the regulatory toolbox with macroprudential tools and measures, a comprehensive recovery and resolution framework and a European network of insurance guarantee schemes. Furthermore, EIOPA supported increasing proportionality across the three pillars of Solvency II, especially regarding low risk undertakings. Solvency II is now being considered by the co-legislators.

Solvency II is a competitive regulatory framework. European insurance groups and insurers successfully do business internationally based on Solvency II. The review of Solvency II should preserve that. We should keep in mind that competitiveness is more than the level of capital requirements and aim for sustainable competitiveness that relies on fair pricing and credible risk assessment, to build resilience and trust.

Turning to the ICS, the IAIS has already achieved great progress working with its members, with the agreement of ICS 2.0 in 2019 and the launch of the five-year monitoring period. Thanks to the information gathered during the past monitoring exercises, we were able to learn from each other and shape the candidate ICS as a Prescribed Capital Requirement (PCR) to appropriately capture the risk profile of Internationally Active Insurance Groups (IAIGs). We strongly believe that the introduction of a minimum risk-based regime globally that reflects the key elements of Solvency II will enhance global financial stability, consumer protection and level playing field across IAIGs. The candidate ICS as a PCR is now tested through the 2023 monitoring exercise and publicly consulted.

EIOPA urges all EU stakeholders to actively engage in the last steps of the ICS

In EIOPA's view, the candidate ICS as a PCR goes in the right direction of implementing sound risk-based supervisory frameworks globally and is consistent with the main features of Solvency II. For example, internal models are now acknowledged as part of the candidate ICS as a PCR, allowing the recognition of the specificities in the risk profiles of large, sophisticated groups.

Another important aspect of the implementation of the ICS is the comparability exercise of the ICS with the Aggregation Method (AM) – not part of the candidate ICS as a PCR – developed by the United States and other interested jurisdictions.

EIOPA believes that the IAIS criteria being used to assess whether the AM provides comparable outcomes to the ICS are sufficiently robust. These criteria were developed to provide a foundation to assess whether the AM delivers comparable outcomes to the ICS.

However, it is important to emphasize that the robustness of these criteria alone does not guarantee the comparability of outcomes. The agreed criteria are merely a framework that guides the assessment process. The true assurance of comparability will have to come through a thorough, evidence-based, and quantitative assessment that builds upon these criteria.

Only through such a rigorous process, that can start once we have a published version of the AM, can the IAIS conclude if it produces similar, even if not necessarily identical, results over time that trigger supervisory action on group capital adequacy grounds.

We are now in the last stage of shaping of the ICS. EIOPA regrets that a number of European IAIGs are not actively taking part in the ICS development process. Together, we can achieve a better ICS that also aligns with the key fundamental principles underlying Solvency II.

EIOPA urges all EU stakeholders to actively engage in the last steps of the ICS. The ICS plane is about to depart, and this is the final boarding call.

FRANK GRUND
Chief Executive Director
Insurance and Pension
Funds Supervision -
Federal Financial Supervisory
Authority, Germany (BaFin)

Improving the risk-based framework in Europe and creating a global framework with the ICS

My opinion is clear: Solvency II has – for the most part – been an undoubted success since its entry into force. The risk-sensitive regulatory framework has been invaluable in enabling the early identification and better assessment of risks. However, as is natural for such a comprehensive framework, it has also become clear that improvement is needed in certain areas. It is with good reason that a review of Solvency II has been initiated.

More tailored treatment of long-term guarantees

With regard to quantitative requirements, the treatment of long-term guarantees takes on a key role. The extrapolation of the interest rate term structure and the volatility adjustment are core measures here. We welcome the fact that the review will lead to targeted improvements in these measures, in line with the idea of "evolution, not revolution". The volatility adjustment, as a result, is expected to have a significantly larger impact – this will require a very careful calibration to avoid "overshooting" effects which may put the functioning of this instrument at risk.

Regarding interest rate risk – another important component in Pillar 1 – the review will lead to more adequate risk measurement: a significant improvement compared with the current status.

Current environment underlines need for risk-adequate supervisory requirements

In recent years, the world has gone through turbulent times. The pandemic, the current geopolitical situation and the recent rise in interest rates and inflation have led to new risks and vulnerabilities. The effects of climate change, too, are becoming more and more evident. Overall, the sentiment in financial markets remains fragile, with a high degree of volatility and uncertainty. In light of all this, it is paramount that we maintain risk-adequate supervisory requirements.

An undue reduction in capital requirements would send out the wrong signal and could damage the foundations of Solvency II, which lie in the adequate identification of risks. We need to maintain a balance; the review must not be at the expense of the resilience of the sector. Against this background, we view the latest policy proposals as a cause for concern.

Reducing the burden on insurers is not an end in itself: such measures must be risk-appropriate.

Proportionality

We welcome the fact that the SII review will strengthen the principle of proportionality by introducing a framework providing for risk-adequate relief measures for small, non-complex insurers. This will facilitate a uniform approach for dealing with companies whose risk profile calls for simpler solutions. But in our efforts to improve proportionality, we must not lose sight of the fact that this is not simply about relief for the sake of relief – and therein lies the challenge. Reducing the burden on insurers is not an end in itself: such measures must be risk-appropriate.

Sustainability: reflecting climate-related risks in Solvency II

It is essential that the increasing climate-related risks are properly reflected in the Solvency II framework. We welcome the sustainability proposals from the EU COM in the SII review. However, it is worth emphasising that Solvency II is a risk-based regime that is not compatible with measures like green supporting or brown penalising factors. A big challenge behind climate-related risks is that – unlike many other risks – they cannot be observed in historical data. We therefore need appropriate forward-looking methodologies to analyse climate risks.

Balancing heterogeneity and standardisation: achievements and challenges of the Insurance Capital Standard (ICS)

At the global level, the International Association of Insurance Supervisors (IAIS) is continuing its work on the Insurance Capital Standard (ICS) based on principles that resemble those of Solvency II. We fully support the introduction of the ICS and its main objective to establish a risk-based consolidated group-wide capital standard for Internationally Active Insurance Groups (IAIGs), which will lead to comparable outcomes across jurisdictions. To ensure a risk-based approach, it is of the utmost importance that internal models are included in the ICS in order to adequately reflect the heterogeneity in the IAIGs' risk profiles.

Currently, the ICS is in public consultation. In addition, the IAIS is assessing whether the aggregation method developed by the USA provides comparable outcomes to the ICS.

Overall, the development of the ICS is already well advanced and, in our view, it has so far been a success. Due to its importance, we welcome the fact that many large European insurance undertakings continue to participate in the process: international insurance groups should not miss this opportunity!

The next steps will depend on the results of the consultation and the outcome of the comparability assessment of the aggregation method. The adoption of the ICS is currently scheduled for late 2024.

MIREILLE AUBRY
Director Prudential Regulation Standards & Foresight - COVEA

Reviewing Solvency II and upgrading insurance resilience & competitiveness

The “2020” Solvency II review was intended and expected to bring improvements in the regulation that entered into force on 1 January 2016 and to the supervision of the insurance sector after having taking stock of its fitness to initial expectations as well as complementary ones in respect of new dimensions such as the drastic evolutions of the macroeconomic environment, sustainability issues and new and evolving risks. Improvements are expected for an enhanced adaptation and relevance of the framework and its continued efficiency with a special strong attention to the long-term instrumental dimension of a resilient and performing insurance sector at the service of the society and the economy.

The relevance of the solvency II production and monitoring is dependent on adequate risk-based valuations serving the clear objective of sustainable resilience based on appropriate indicators while putting the interest and security of policyholders at the core. Markets, regulation and supervision should serve the interest of citizens and not the contrary.

An efficient regulatory framework should be robust, cost effective without unwarranted interferences. By robust we mean a regulation that avoids being biased to temporary and/or short-term conditions as well as averts over parametrizing valuations that renders modelling fragile and bound to inappropriate swings that can trigger poor decisions to the detriment of adequate balance and counter-cyclicality. Bias towards artificial consensus should also be avoided and topical situations must be correctly reflected to avoid destroying innovation, diversified approaches and models that are utmost valuable for effective adaptation to different needs and diverse risks.

To improve reliability the key items under intense scrutiny and expectation for adequate calibration for the solvency II review are the discounting risk free yield curve, the interest rate risk and the risk margin and additionally to enhance insurers’ investment capacity the long-term equity risk.

Under the EIOPA’s proposal for a new extrapolation methodology for the yield curve of basic risk-free interest rates used to discount the best estimates of insurance liabilities the convergence alpha parameter towards the ultimate forward rate or long-term anchor parameter is too low when set at 10% and the industry is expecting a value of at least 15%. This is working against the stability of the prudential reserves and is leading to exaggerated volatility immediately affecting the own funds and in turn increasing the volatility of solvency ratios.

The volatility adjustment is another major fitting factor that should account for adequate discounting so that assets and liabilities movements display consistent behaviors and that unsuitable assessments of risks are avoided in the context of long-term asset and liability management whereby fixed income securities are held until maturity. It is paramount that the volatility adjustment fulfills its role notably in turmoil times to work against amplifying the crisis and triggering counterproductive actions.

In the same vein the EC’s proposal to extrapolate the curve beyond its liquid part under the SCR interest rate shock is key to consistency of approaches with the calculation of the best estimates in the central prudential balance sheet and to maintain a limitation to overstated volatility.

The risk margin is providing an addition to the best estimates to ensure the transferability of reserves. This should nevertheless not conduce to harming long term liabilities insurance products with prohibitive costs while long term should factor the time-dependence of risks in the projection of future capital requirements, with later years having a lesser contribution to the risk margin and more stabilized long-term charges should be promoted.

Last, in order to enhance the insurers’ investment capacities and their crucial role to financing a sustainable economy, the criteria governing the eligibility of equity portfolios to the long-term equity risk are long awaited to be workable and reflective of the key drivers of long-term investment strategies while preserving the agility of such investments so that they remain performing with the best prospects. The choice of the market timing must remain in the hand of insurers’ tactical monitoring enabling timely and countercyclical sales and purchases.

An efficient regulatory framework should be robust, cost effective without unwarranted interferences.

On the field of competitivity, it is worth noting that the IAIS’s Insurance Capital Standard (ICS) project which is based on Solvency II was intended to create the conditions for fairer markets at global level. The finding is that the ICS generally requires less capital than Solvency II but more than other frameworks.

The Solvency II review is an opportunity not to be missed to fix the unlevel playing field by which European insurers have to hold more capital and are disincentivized to act long-term to prepare a more resilient future. European insurers have less investment capacity and are impeded with their products offering.