SOLVENCY II REVIEW: KEY ISSUES

1. The current context

1.1 Solvency II has proven to be a robust framework, but it must evolve to address emerging challenges

The review of Solvency II is particularly relevant in the current unprecedented economic context that has resulted from the pandemic, as well as in the context of emerging risks arising from climate change and low-for-long interest rates.

The robustness, strength, and flexibility of the supervisory framework has been demonstrated considering the current crisis. Countercyclical mechanisms provided by the current Solvency II regime were helpful in dampening the effects of market volatility. The framework has also helped to avoid procyclical behaviours.

However, some aspects of Solvency II still need to be improved upon in order to take into account the current economic environment as well as upcoming challenges. In particular, the current pandemic and the climate-related risk context have unveiled challenges for the insurance sector related to business interruption protection and the existing insurance protection gap. Considering this, the European Insurance and Occupational Pensions Authority (EIOPA) delivered its final piece of advice on the Solvency II review in December 2020.

1.2 The EU insurance sector has demonstrated its solvency and flexibility in the current challenging context

An industry representative stated that the insurance sector is often not given enough credit for being flexible, and yet it demonstrated flexibility in coping with the pandemic and subsequent economic crisis, which has been a real stress test for the insurance business across almost all business lines. Thanks to the massive application of digital technologies, the industry was able to maintain business continuity and offer services to its customers while simultaneously protecting agents and employees.

The internal capital position and the initial level of solvency allowed the industry to cope with the short-term volatility caused by the deterioration of the financial market at the beginning of the pandemic. In the first and second quarter, internal operating profits and a well-diversified portfolio allowed for the compensation of higher claims or less premiums in some lines of business with reduced claim frequency in the other lines. By demonstrating stability in the face of Covid, the insurance sector is still perceived as a safe place to invest money in the long-term.

1.3 The review should address various emerging challenges

A regulator stressed that the main challenge in relation to the Solvency II review is reality, be that the reality of many years of low interest rates, of the ongoing Covid epidemic or of climate change, which has a particular impact on insurers given their role as risk managers for the whole economy. The challenge for EIOPA and the 27 national supervisors is to consider what changes to Solvency II should be recommended considering these realities.

A regulator commended EIOPA's technical advice on the Solvency II review as a 'very good starting point', noting that it is now for the European Commission to come forward with its official proposal, which is expected to be adopted in July. In preparing that proposal, the European Commission should take into account the range of different issues such as: an ageing population; the role of institutional investors in achieving political goals such as the Capital Markets Union and the European Green Deal; the risks attached to equity and debt instruments; and policyholder protection.

1.4 Fundamental changes are not necessary

A regulator stated that fundamental changes to Solvency II are not required, particularly in light of the strength that has been demonstrated in coping with the current adverse realities. EIOPA's approach to Solvency II is therefore 'evolution, not revolution'.

Another regulator concurred that Solvency II has proven to be an effective tool and an effective framework in the wake of the Covid crisis, bolstered by the lessons learned from the financial crisis at the beginning of the decade. Evolution is therefore preferable to revolution, with fine-tuning and completing the framework where necessary in order to, for example, take account of the current environment of negative interest rates, and deepen the integration of the insurance sector across the whole European Union.

An industry representative stressed that all participants share a common goal, which is to make this review a success. There is a consensus among the community of both insurance undertakings and supervisory authorities that, while the Solvency II framework is not perfect, it is working, and it is important not to break what is actually working. The implementation of Solvency II has helped EU insurers to better align the capital level with risk, to build up resilience and to enhance risk management practices. Crucially, the framework has allowed insurers to withstand the Covid crisis without suffering damages that the current level of capital would not allow them to support, and to do so without calling for public support.

Another industry representative agreed that no fundamental changes are needed, and that adaptation is preferable to revolution, notably with regard to long-term business models. The ability of insurers to take risks and to invest in the economy with long-term strategies needs to be recognised and facilitated rather than impeded.

2. The main issues to be solved

2.1 Specific changes

2.1.1 Addressing the low-for-long situation specific to interest rates

A regulator noted that EIOPA has identified the need to change the treatment of interest rate risks to cater for the environment of negative interest rates and to ensure that enough capital is held by insurers against this risk.

Another regulator added that the way in which capital requirements for interest rate risks are calculated should be corrected in order to take account of the changes in the economic environment and the appearance of negative interest rates. A question that remains unresolved is where the cap should be in the downwards scenario.

2.1.2 Regulatory phase-in periods to dampen the impact of the Covid-19 crisis in the short term

A regulator stated that the long-term perspective of EIOPA's advice needs to be disentangled from the short-term impact of the current Covid-19 situation. An 'emergency brake' has therefore been proposed to the application of the extrapolation of interest rates when interest rate levels were below that of the end of 2019.

2.1.3 Fine-tuning the volatility adjustment

A regulator called for the volatility adjustment (VA) to be fine-tuned so that it can be better applied to longer-term and illiquid liabilities. A permanent VA component would be applied to these illiquid liabilities because the short-term volatility is not relevant since assets are being held that are intended to be kept. The macroeconomic component of the VA also needs to be fine-tuned. In particular, the VA tool needs to provide adequate relief where market fragmentation arises because of divergent economic realities across the different countries in the euro area.

2.1.4 Attention is required on possible asset bubbles

A regulator noted that EIOPA has provided a cautious position on a so-called 'green supporting factor' in a separate 2019 opinion. EIOPA is also proposing to move the frontier here in areas such as the inclusion of climate change risks in the own risk and solvency assessment (ORSA).

Another regulator noted that the insurance sector is a fundamental player in the post-Covid economic recovery and in the green and digital transformations. The policies that need to be in place to ensure that the insurance sector can play its role do not arise simply from the prudential regime, but, as a prudential regime, Solvency II must remain risk-based and evidence-based. Where uncertainty remains about the risks stemming from new assets, Solvency II needs to fully reflect appropriate risk-sharing mechanisms.

2.1.5 A macroprudential approach to recovery and resolution provisions to address notably systemic risks

A regulator highlighted the need to supplement the current microprudential framework of Solvency II with the macroprudential perspective, both in relation to systemic risk and recommendations on recovery and resolution, as well as minimum harmonised insurance guarantee schemes.

Another regulator stated that the recovery and resolution element, together with the insurance guarantee schemes, are fundamental pieces to add to the regime.

2.1.6 Cyber-risk

A regulator noted that digitalisation provides opportunities in terms of new products such as cyber-risk insurance and autonomous driving liability insurance, but that it also increases the possibility of cyber-attacks and insurance fraud.

2.2 The framework requires more proportionality

A regulator stressed that the Solvency II review should make proportionality a practical reality rather than just a theoretical principle, so that the regime is more fit for purpose, particularly for small- and medium-sized insurers.

Another regulator noted that a more risk-sensitive regime can lead to greater complexity, and that the appropriate balance therefore needs to be struck. The measures need to be logical and understandable with outcomes that can be anticipated in different scenarios.

2.3 The framework should accentuate the role of the insurance industry as a long-term investor

A regulator highlighted EIOPA's advice, which concluded that a more favourable but still prudent treatment of long-term investments is possible, as reflected in the recommendations for changes to the VA, to the risk margin and for equities that backed long-term and illiquid liabilities.

An industry representative stressed that excessive conservatism is a threat to the whole sector as it brings prohibitive costs. For these reasons, the VA and the long-term equity reduced shock need to work effectively as they represent key elements for the long-term investments in bonds and equities.

Another industry representative stated that, although market and asset prices are volatile, the fact that insurers are long-term asset holders needs to be reflected.

2.4 Addressing the remaining factors of procyclicality that prevent insurance companies from fully behaving as long-term asset holders

An industry representative stressed the need for the Solvency II framework to reflect the economic reality of low, or negative, interest rates, which are set to last. Furthermore, weaknesses in the current framework have been magnified during the financial turmoil, which mainly revolve around the excessive volatility left in the framework.

Another industry representative added that the low interest rate environment is probably the biggest challenge facing the industry. Low rates are putting pressure on the European life insurer where products with guaranteed returns in the past still represent the lion's share of the total portfolio.

An industry representative stated that the prolonged low interest rate environment is the key economic issue that needs to be addressed under the current review. Although Solvency II is strongly supported by the insurance industry, some excessively conservative elements remain.

Solvency II already comprises several mechanisms to address the low interest rate environment, such as stress testing in ORSAs. EIOPA is also performing sector-wide stress tests, checking the industry's resilience against further declines in interest rates. Most importantly, insurers are required to hold risk capital against a further decline in interest rates. For internal models, this capital is calculated based on forward-looking assessments of implied price information. For the standard formula, negative rates have not been adequately tackled so far, so the changes suggested by EIOPA are supported in principle, although the calibration may still be too conservative.

The current extrapolation methodology defines an interest rate curve beyond the last liquid maturity, defined as the last liquid point at the 20-year mark up to the ultimate forward rate at the 60-year mark. There is no reliable market for very long maturities, and objective definitions of very long-term rates are not possible. Any type of extrapolation method therefore includes subjective elements. Excessive market volatility driven by short-term events should not be transferred to the valuation of long-term stable insurance liabilities. Under EIOPA's new proposal, the starting level of the extrapolated part of the interest rate curve is dependent on swap rates beyond 20 years, now up to 50 years. These are not liquid and therefore are prone to excessive volatility. EIOPA has also introduced a new parameter that extends the maturity of the ultimate forward rate up to 100 years. As a result, a substantial decline in the solvency ratios for insurance companies can be expected, alongside an increase in solvency volatility.

There is also ample evidence that long-term forward rates are poor forecasts for actual future rates. The situation is aggravated by the current environment where interest rates are being distorted by unparalleled asset purchase programmes of central banks.

2.5 Conservative calibrations and inaccurate risk assessment approaches hamper the ability of the sector to invest

2.5.1 Inappropriate regulatory treatment of the low-for-long context risks further reducing insurance undertakings' long-term guarantees offerings and related investments

An industry representative stated that an 'emergency brake' is proposed to dampen the implications arising from proposed extrapolation methodology. It is phased out until 2032 but it also comes with a range of restrictions regarding capital distributions in combination with specific reporting requirements. To mitigate the resulting solvency effects, issuers will be pushed to divest from real long-term assets, relinquish the long-term offering of guarantees or increase costs to customers.

2.5.2 An over-calibrated risk margin reduces investment possibilities

An industry representative stated that there is currently excessive conservatism in calibrating the risk margin, which deters long-term investments. EIOPA has acknowledged one of the three strong justifications for lowering the risk margin, which is the introduction of a factor to recognise that the risk is not constant over time. Nevertheless, the risk margin represents €160 billion for the entire European insurance industry. It also introduces volatility in the framework because the risk margin increases when interest rates get lower. Other changes are needed to get to an appropriate level, and the cost of capital embedded in the risk margin should also be in the works.

2.5.3 The proposed liquidity ratio does not yet reflect the ability of insurance undertakings to avoid forced sales

An industry representative disagreed with the excessive conservatism and elevated procyclicality of EIOPA's proposed liquidity ratio, which does not assess whether the product features and the associated risks are indeed under control. Where an asset and liability management (ALM) policy ensures the availability of sufficient levels of asset inflows to avoid cases of forced sales, there is no reason to reduce the compensation of artificial volatility. The ability to earn risk-corrected spreads needs to be fully recognised, and an adjustment makes sense only if it is based on an actual risk of forced sales.

2.5.4 Spread behaviours do not appropriately capture the probability of counterparts' default

An industry representative maintained that the risk of default that the risk correction is meant to encapsulate can only be derived from historical data series. No one point in time of spread behaviour is an adequate estimate of defaults. The proposed new calibration would therefore be highly procyclical where there are exaggerations of spreads. In addition, there is an overstatement of the credit risk in the Solvency Capital Requirement (SCR).

2.6 The likely future cashflow gaps and the risk of forced sales are not appropriately captured

An industry representative stated that EIOPA's opinion is reflective of how long-term equity investment strategies are put in place and greatly improves the eligibility criteria of article 171a. However, an unwelcome change is envisaged under the demonstration of the actual resilience of the investment portfolio to short-term losses, where there is a punitive liquidity ratio for non-life portfolios. Changing eligibility criteria to long term equity investments as suggested by EIOPA would further impede long term investments. Any liquidity ratio approach should be based on cash flows rather than stocks and on an adequate liquidity monitoring horizon (1 year to 5 years maximum).

2.7 The need to reflect the specificities of the insurance business model

A regulator noted that the review provides an opportunity to improve the efficiency and effectiveness of Solvency II so that it better reflects specific features of the insurance sector. The regime needs to reduce existing protection gaps, foster innovation, protect the international competitiveness of the European market, and protect policyholders.

2.8 The proposed macroprudential measures do not account for the recently demonstrated soundness of the sector or the efficiency of the regulatory framework

An industry representative disagreed with the macroprudential policy in EIOPA's proposal, which may have been taken from the Global Systemically Important Institutions (G-SII) framework since the existing Solvency II framework had allowed for a high level of protection, and additional capital buffers would only be detrimental for competitiveness.

2.9 The proposed regulatory treatment of systemic risks increases the nexus of the insurance sector with the banking system

An industry representative noted that EIOPA's proposal would coerce insurers to increase the use of derivatives in their asset liability management and hence increase the nexus to the banking system, which is problematic from a prudential perspective.

3. Additional policy objectives

3.1 Regulatory uncertainty

An industry representative stressed that there is no need for additional uncertainty or volatility arising from regulation, particularly in the current difficult context where the Solvency II framework has worked rather well. Care must be taken not to introduce too many addendums or capital burdens that could undermine the Solvency II approach.

3.2 The appropriate level of regulatory capital

An industry representative stated that the solvency ratio should not be substantially affected in the long term or the short term. In addition, the rules for setting and updating the calibration in the legislation should be clearly specified. Ultimately, there is an opportunity to better align the framework with the underlying economic risk, which should not be missed.

A regulator stressed the importance of balance. The goal of the Board of Supervisors was to deliver a balanced package. With the figures at the end of 2019, there was no desire to have additional capital requirements or additional volatility, per se, because the system worked well and there is no need to go beyond the capital requirements as such.

EIOPA's goal was to have this balanced package without considering the interest rate risk calibration and to do so only at the European level. It can be questioned whether this is the right definition of balance or whether such a definition should do without the interest rate risk. In addition, it can be questioned whether such a definition should take account of the member state level, product levels and the future needs of society. In terms of extrapolation, it can be argued that the right balance has not been achieved with regard to all these aspects. Ultimately, a focus on the term 'balance' could lead to a better outcome.