# SOLVENCY II REVIEW: LOW FOR LONG AND LONG-TERM INVESTMENT CHALLENGES

## 1. EU insurance regulatory framework: what is at stake at present?

A public sector speaker commented that the Commission will issue its Solvency II review in September, with amendments to the Solvency II Directive and a proposal for a standalone directive on insurance recovery and resolution. Solvency II's introduction in 2016 was a revolution in the rulebook for European insurers and the conclusion is that it is a success. Prudential rules align with advanced risk management practices and the sector entered the crisis in a strong position. Another revolution is not needed, but targeted improvements to the framework are, and the Commission has worked in four areas: first, helping the insurance industry to actively develop Capital Markets Union (CMU) and the European Green Deal; second, improving risk sensitivity in Solvency II in the low-yield environment; third, proportionality is a core principle, but has not worked well in practice, so how to improve it has been reviewed; fourth, enhancing policyholder protection and financial stability, at recovery and resolution and for cross-border insurance services provision.

### 1.1 Despite the EU insurance industry's soundness, macroeconomic challenges are transforming insurers' risk profiles and business models, and bringing new regulatory challenges

An industry representative noted that insurers are confronted with many challenges. Low rates bite profitability, and a lack of profitability affects viability. That needs a response, which is to look at a portfolio's asset and liability side. On the liability side, there is business profitability pressure. Insurers may take more conduct risk and enhance their appetite to keep the same profitability level. Insurers are advised to take care of this and regulators to monitor it. As with COVID, in a stressed profitability situation, decisions may be made on opportunity cost, which may push insurers out of lines of business, removing society's protection in areas like business interruption. The liability challenge must not be underestimated. On the asset side, low rates mean searching for yield and taking more risk, and so there is good and bad news. The good is that regulators are aware of this. The bad is that low rates came with quantitative easing, which distorts the risk price and the return received from it. Spreads are totally distorted.

If credit spread is distorted, insurers are tempted to try to earn it on the liquidity side, where the correction is seen as lesser, via 30 or 40-year paper. Supply of that paper is insufficient to meet the demand, so insurers go to the less deep and transparent markets and take more illiquidity risk that will need to be managed. If there is proper due diligence and understanding of these risks, things will be well. Insurers may think they are invulnerable as they coped well with the 2008 crisis and, in April, regulators found there was no liquidity crisis for insurers. That experience should not create the belief that this will never be an issue, as then guards will be low.

An industry representative stated that insurers have faced different crises recently, with the 2019 interest rate reduction and then COVID, with a crisis on the interest rate, the financial markets and the technical part. Overall, insurers were resilient in facing these shocks. Solvency II helped, although it is not perfect and can evolve. Through the stress tests and the crisis, relations with the regulator were good, with monitoring that allowed insurers to adapt to the low-rate environment. Insurers are also transforming business models. There has been a push towards a unit-linked model, which helps to change balance sheets. Something to consider is that insurers in the crisis have been good but are changing business models.

### 1.2 Clarifying regulation and accounting standards' role in the long-term behaviour of EU insurance undertakings is necessary to address fast-developing challenges faced by society and the economy

An industry representative stated there is a need to ramp up long-term investments to benefit the economy at large, the insurers and the insured. Investing for the long term is imperative for the future. What matters is not maximising immediate profits but creating long-term value for society through commitments in the economy. A feature of the past 20 years is the drop in equity investments of insurers. This is primarily insurers' in-house experience but is substantiated by sources like the OECD or the December 2019 Deloitte study, which says: 'While we face some difficulties when assessing equity allocations over historical data series or even still sometimes today, because of the lack of granularity and consistency, an obvious significant decline comes out, yet that can differ between countries in Europe and also between insurers, depending on their risk appetite and strategies. Important drops appear to follow past financial prices, which is certainly the result of several factors, among which the economic environment, the introduction of new accounting and prudential rules appear dominant'.

Studies suggest that average equity investments in Europe are below adequate allocations by 5% of total investment, which is significant. That can be linked to past prices, but this is not obvious. New accounting and prudential regulation standards based on market values inducing volatility in published accounts and excessive cost of capital cannot be ignored. Explanations for low equity investment are supported by a recent Louis Bachelier Institute study which analyses optimal asset allocations derived from the assets and liabilities risk profiles with the search of an optimal asset allocation for a long-term investor. Solvency II constraints are leading to a significant decrease in asset allocations to non-bond assets, for instance, more than halved for equities.

A regulator commented that Solvency II does not appear to have materially affect insurers' equity investments. The situation is different in different countries and jurisdictions depending on insurers' risk appetite, so there is no clear evidence. Overall, the insurance sector's equity investment is stable from 2011, so the evidence does not confirm the study, which is interesting, as everything is when fostering equity investment. Supervisors want to foster economic recovery but will look for evidence. The study's methodology is understood, as its forward-looking approach is not as granular as the regime. New criteria were proposed to qualify long-term equity investment, with measures to foster illiquid liability being invested increasingly in long-term investments and equity. There is a desire to bridge the debate between sceptical supervisors and the industry, which is pushing forward. There is a common interest in understanding what keeps the sector stable and solvent, and how to continue to foster investment in long-term equity. This is the main objective, so it is vital to continue to work together.

### 1.3 EU regulatory frameworks' relevance should be improved by addressing the short-term volatility of existing or envisaged regulatory measures separate to the insurance business's fundamentals

A public sector speaker noted that Solvency II's impact on insurance companies' equity investments is still unclear. An industry representative stated that low interest rates might continue even if concerns over increasing inflation, lead to an evolving macro-economic environment. Credit spreads are sensitive to financial turmoil and increasing volatility of the solvency ratio, as in the COVID period. Given the long-term investment nature of the insurance business and that the solvency position remained solid across the European insurance market at well above 180%, this short-term volatility has nothing to do with the insurance business's true economic fundamentals.

The solvency ratio's short-term fluctuation requires insurers to provide counter-intuitive explanations of the artificial nature of this phenomenon to investors and the market. To hedge against unexpected fluctuations, insurers are inclined to have a capital buffer well above solvency capital requirements (SCR), leading to over-conservatism and missed investment opportunities. High capitalisation induces an insurance company toward the creation of capital products such as unit-linked or hybrid, in a world of demographic and social trends towards an aging population and a low-income young population that demand pension protection products. Sub-optimal capital allocation risks unnecessary management decisions and deviates from an appropriate asset liability management (ALM) strategy. Solvency II is a qualified success since its inception in 2016. Measures like the volatility adjustments (VA) support the reduction of such short-term volatility. The VA mechanism can be improved, but EIOPA's proposals in the Solvency II review seem to contradict the VA's spirit, such as the risk correction and the liquidity application ratio. If not improved, the industry will set aside too much capital, reducing the flow of funds to the real economy, which is especially vital now.

### 1.4 Achieving consistency in EU risk assessment tools for sustainability challenges is necessary

An industry representative highlighted the shift to a green economy driven by the Paris Agreement, the Net-Zero Asset Owner Alliance and Net-Zero Insurance Alliance. This requires a fundamental review of revenue-generating sources and the operating process to extend the current risk management framework to manage and report risks related to those commitments and the others that will follow in the future. Climate change stress tests and scenario analyses have been anticipated from the national supervisory authorities (NSAs) , which do not converge and start from different assumptions. There should be one risk management framework for multi-territorial insurance groups. NSAs and EIOPA are invited to harmonise requests as much as possible with clear guidelines, rather than specific prescriptive technical measures, to guarantee future exercises' success.

## 2. Challenges posed to the regulatory framework by emerging macroeconomic challenges

### 2.1 The current regulatory framework encourages insurers to model new macroeconomic risk

A regulator stated that whether a risk-based regulatory framework can address all the macroeconomic scenarios is a philosophical question, as there is uncertainty about such scenarios' impact. Solvency II is a risk-based regulatory framework, which does not exclude any specific risk, and although risks from macroeconomic scenarios were not the focus when it was adopted, it does not ignore them. Understanding of the pandemic's impact changed with time, and with macroeconomic risks there is a learning process. Such risks are not specifically foreseen in the standard formula for calculating the SCR, but insurance undertakings are not restricted to analysing risks identified in the standard formula and can develop an internal model. Nothing stops them considering risks from macroeconomic scenarios; indeed, the regulatory framework encourages them to take a forward-looking perspective on risks.

### 2.2 Unanticipated risks challenge the clarity of insurance policies and the insurability of these risks

A regulator commented that the pandemic showed the importance of writing general conditions in insurance policies unambiguously. Several European countries' courts had to deal with unclear wording in business interruption policies in 2020. If it is not clear, there will be dissatisfied policyholders, which supervisors do not want, and inappropriate risk assessment and pricing from insurance companies. Climate change poses many challenges to the insurability of climate-related risk and makes risk assessment harder, as companies cannot rely on data due to the frequency and severity of natural catastrophes. Risk prevention is important, and insurance must encourage policyholder activities to reduce climate change risks and lower risk in premiums. Risk-aware behaviour reduces risk associated with extreme events caused by climate change. A lesson from the pandemic is that the private sector alone cannot cover all damages from these risks. Besides taking responsible attitudes in relations with consumers, insurers should cooperate with public authorities to develop private-public partnership solutions that provide even better protection.

**2.3 Political considerations in the EU insurance prudential framework would weaken its credibility**

A regulator commented that many risks affect the industry, like the low-yield environment, climate change, digitalisation and asset price bubbles. Business models are flexible enough to adapt and deal with emerging risks. Climate change may increase the number and severity of catastrophes like the recent floods. This will negatively impact some insurers' profitability this year, but in the medium and long term they can adapt reinsurance strategies and exit specific risks. They can manage this in the framework. Solvency II aims to capture all material risks on a micro level. It should not be disturbed by political or macroeconomic considerations, so adjustments which are not risk-based are unwelcome. A macroeconomic scenario without assessable financial risks is a political ambition. Green support and a brown penalising factor were discussed in 2020 and 2021 with an industry-wide dividend ban for insurers and banks, irrespective of the risk-based capacity. The system should not cover these and if they are macroeconomic scenarios then the risk-based system cannot capture all these scenarios and should not do so.

**2.4 Emerging risks tailor expectations between undertakings, the public sector and consumers**

A public representative stated that there is a historical shift in the role of insurance in societies, which impacts citizens and companies. For centuries, insurers pushed at the frontiers of what can be insured, which is a foundation of the economic growth model, but now it is often said that the challenges society faces, such as the consequences of climate change, civil resilience, or pandemic risk, cannot be insured. There is an expectation that public authorities will step in when insurance coverage stops. The public sector is asked to 'do the dirty work,' and the private insurance sector takes care of the lower-hanging fruit. This will feed into the Solvency II debate as it touches upon society's tolerance to risk.

The Solvency II review should be rooted in a broad debate on managing expectations for insurance. Key aspects must be improved, such as transparency on cost and coverage, so aligning packaged retail investment and insurance-based products (PRIIPS) and the Insurance Distribution Directive (IDD) is vital. Accountability over time is needed to avoid a sudden increase in cost or decrease in coverage. There should be a regular dialogue between consumers and insurers, not only in bad times. The Solvency II review is not only a technical exercise. It is about redefining society, the social approach to insurance, and expectations from businesses and consumers. Commentary on the need to work together is positive.

## 3. Specific priorities for the Solvency II review

**3.1 The role of insurers and supervisory approaches for the EU's cross-border insurance business**

A regulator noted that Solvency II is a success, but refinement to maintain the framework as fit for purpose is needed. Something on long-term investments was observed and proposed to the Commission and may be included or not. Suggestions were made on improving the VA, the risk margin, and the equity risk, especially for illiquid and long-term liabilities. This can be the right incentive to push forward the insurance sector's natural long-term investment intentions. The low interest rate environment needs to be faced. There are plenty of studies. Solvency II was designed before this environment arose, so it is important to take account of reality and face it, whether it is liked or not. This was considered when providing input on adjusting the module on interest rate and curves for discounting liability. The supervisory community believes it is important to highlight this area of concern.

The proportionality principle is a basis of Solvency II that can and should be improved as experience shows that more can be done in applying the framework for the low risk undertaking. Criteria must be defined to identify low-risk undertakings, taking account of the size, nature and complexity of the business. After a simple notification to the supervisor, there should be an automatic application of measures on governance and reporting, as this can foster the application of the principle after the first year of experience. This is not completely revolutionary, but is lessons learned from experience. There is a desire to complement the framework and a separate directive on recovery and resolution is being considered. More was asked for, including a minimum harmonisation on the insurance guarantee scheme. This is important due to the cross-border dimension of the insurance business, to ensure that all European citizens are protected at the same level, regardless of whether they buy their insurance product in the home country or another one in the EU internal market.

A public representative stated that this is a key review for the insurance ecosystem, and as the Chair wrote, the Solvency II review can be a tool to achieve three overarching priorities. First, insurers will channel more investments into long-term and sustainable projects if pushed gently, which means more equity and financing and contributing to the European Green Deal. Second, a cross-border supervision solution requires a balanced approach with stronger regulation and more effective supervision. Third, the effects of 'low for long' on the insurance ecosystem must be kept in mind. The Commission's proposals on the VA, the risk margin and interest rate risk following EIOPA's suggestion are anticipated.

A regulator commented that Solvency II is a complex risk-based framework, and its revision is perhaps more complex than the introduction itself. The industry and supervisors were prepared for the introduction of Solvency II and the transition went smoothly. Hopefully, the revision will go as smoothly. From a supervisor's perspective, there are some weaknesses in the Solvency II regime, including the failure to recognise that interest rates might be negative in calculating the capital requirement and the inadequate methodology for long-term liabilities' devaluation. Then there is insufficient application of the proportionality principle, which should be applied more often in practice and kick in almost automatically when conditions are satisfied. When EU stakeholders were consulted, the response was that the insurance market is diversified and not everyone is happy with the EIOPA proposals. These weaknesses are of common interest to all stakeholders. Differences between member states should be considered and the framework made less burdensome for insurance undertakings by simplifying and streamlining reporting requirements. Solutions for devaluing long-term liabilities and improved capital treatment for long-term investment should enable insurance undertakings to join in the transition towards a carbon-free economy.

### 3.2 Key performance indicators of an effective evolution of the framework

An industry representative noted that the Solvency Framework worked well in the post-pandemic stress situation. Solvency II's revision is technical and political, as other panellists said. Insurance is an important source of long-term funding for business and governments, and it is vital to encourage long-term investments in the real economy. Technical flows must be resolved. The framework worked well, but adjustments are needed, including the VA, spread risk on corporate bonds and others.

An industry representative thought that alignment is close. A revolution of the framework is not wanted, but more of an evolution. It should be neutral on capital, as there is enough capital in the industry, and it should foster investment in equity and a less procyclical framework, conducive to short-term action. On the neutral framework, the negative interest rate is key. Nobody can be against a revision of interest rates, but it is important to review that carefully, especially volatility. A 100-basis point drop of interest rates might happen frequently at 5%, but in negative interest rates the volatility might be lower, so the calibration has a huge impact on how the neutral transformation is done. The negative interest rate must be accounted for and ways of compensating it found. A framework to invest in long-term assets is critical. As the CFO of an insurer with more than €12 billion of assets, the Solvency Framework is a key metric for investing short or long term, equity or non-equity. The decisions made on Solvency II will be crucial on how the 10,000 million of passive that the insurer has in Europe will be invested. That is technical, but each decision has an impact. For less procyclical activity, it is vital to find a way to better absorb shocks over the period.

### 3.3 The competitiveness of the EU's insurance sector must be maintained in relation to other regions

An industry representative stated that it is crucial to ensure that the European insurance industry remains competitive at international level and consider how other countries and regions promote insurers' role in society. EIOPA's proposals for a capital surcharge for systemic risk or the possibility to restrict or suspend dividends should be reconsidered. EIOPA has made huge efforts to revise Solvency II, but a courageous commitment is expected to avoid excessive procyclicality in the excess capital charge. A huge increase in capital is not the solution to any problem. This is a healthy industry with large resources, and its financial stability and solidity was evident during the crisis. Further effort is necessary to improve EIOPA's proposal in the interest of the competitiveness of the industry.

An industry representative commented that expectations are high that the review finishes Omnibus II's work in finetuning the framework so that Solvency II can be instrumental in supporting long term investments which are so needed in the environment of recovery and sustainability. The regime must remain market consistent, so value assets at market values for transparency, comparability, economic reasons and relevance, while reflecting long-term business model profiles for their real risks. Assets are traded at market values, so they convey important information that are yet to be handled in the context of the insurers business models in other words the timing of investments and divestments' is critical to shape the realization of profits and losses.  Insurers' asset portfolios are managed long-term, which exposes them to risks in a different way from losses resulting from the full sale-out of their assets at the worst time based on adverse short-term volatility. Insurers are rather exposed to counterparty default risks, insufficient returns and performance in the long run, not to short-term valuations Liquidity mismatches are well under control with ad hoc ALM. The Solvency II review must deliver enhanced adequacy of balance sheet liabilities' valuation and a suitable calibration of risks.

On equity investment, eligibility for the reduced capital charge introduced by the 2018 review should be effective. Complexity and inadequacy still prevail. The long-term management of equities must be recognised for assets backing risk margins and own funds as well as assets backing best estimates. Own funds, notably core tier one, have the longest durations and the regime should do justice to their long-term stance and the resilience they bring to liabilities. They enhance liquidity risk management, which should be conducive of good risk management incentives. Criteria (g) of Article 17(a) does not need to be changed and liquidity stress testing remains the best demonstration of the absence exposure to forced sales.

### 3.4 Preserving the sector's ability to match national specificities requires further adjustments

A regulator considered that balance on a national basis is the priority. It has to be accepted that markets are national, especially in the life business, for accounting, tax and other reasons. An unbalanced Solvency II review could cause substantial risks for insurers and lead to unwanted market exits. The proposal means stronger capital requirements but will not bring more capital into the system. Investors will not invest additional capital into life insurers, and the consequence will be reduced solvency ratios, less ability to act countercyclically and possibly more run-off cases. For a supervisor, that is not a nice idea.

### 3.5 Giving attention to assets' risk specificities to adequately 'green' the Solvency II framework

An industry representative stated that the opportunity to enhance Solvency II and make it greener should be taken. Eurofi has the bringing of new ideas in its DNA. A new idea needs a purpose, and that is to make Solvency II greener. Incentives must be created within the framework to address transition risk, which is underestimated by many, particularly for asset holding. A proposal could focus on the long-term guarantee package, particularly on VA and matching adjustment (MA) because of relevance, and to avoid criticism such as that from the UK stating that VA and MA are skewed against green investment. This must be addressed as it is not necessarily factual.

On methodology, there is a need to set red lines, and a fundamental one is not bringing a green supporting factor, so that should be avoided. It needs to be simple. Solvency II is too complicated. It should be simple to implement, because waiting to change the whole Directive means it will be in 2025, or 2026 perhaps. Something needs to be embedded in the framework, and the framework recognises in its recitals that there are assets and investments with higher recoverability, and evidence is needed. Literature and data have been collected, particularly by Moody's, showing that the recoverability of investment in green infrastructure is higher than the average recoverability of other paper. On this basis the proposal could be that when calculating VA and MA, part of the credit risk is taken out and a flat standard for any type of asset percentage of 30% of recoverability ratio is taken, which is clearly justified for green investment, infrastructure, or bonds, like the one the Commission, amongst others, are pushing. It merits looking at and considering deviating from 30% to make it bigger.