SOLVENCY II REVISION

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Solvency II: improving on the Gold Standard

The European Union is currently facing a multitude of challenges. Some of them are more acute such as handling the fallout of the Russian aggression in Ukraine, others such as the challenges related to the green and digital transition or dealing with the impact of unfavourable demographic trends are more of a slow-burn problem. On many of those challenges, insurance undertakings can be useful allies: due to their long-term business model, they are natural long-term investors that could deploy vast amounts of capital into illiquid assets. That could give a boost to the digital and green transitions. Furthermore, insurance companies offer the kind of long-term financial instruments such as life-insurance policies that can help people plan for a successful and dignified retirement. In light of the pressure public pension systems are under, this can be an important contribution helping to deal with the demographic developments.

In a nutshell: insurance companies can help address many of our most pressing policy problems. Of course, we need to set a regulatory framework that allows insurance companies to do just that. For that, Solvency II is the key policy tool. We should use the ongoing revision of Solvency II to make European insurance companies more agile and more competitive. The overarching objective though is to put insurance companies in a position to offer policies that are attractive and safe and to empower them to fulfil their role as long-term investors.

The current calibration of Solvency II is very conservative and there are still some buttons we can push in order to make European insurance companies more competitive without compromising on financial stability. There are two main avenues that we should look at to achieve those objectives.

> **Insurance companies can help address many of our most pressing policy problems.**

The first one are the technical details of the calibration of certain key variables under the headline “long term guarantees” (such as the extrapolation of the interest-rate curve, the prudential treatment of equity and long-term investments or the adjustment of the risk margin). Many of those variables are currently dealt with as part of the delegated regulation and unfortunately the European Commission has suggested to keep it that way in its legislative proposal. This is not a desirable status quo though. To put it simply: those are the variables that make or break an insurance company. Little tweaks in those numbers can free up billions of Euros or they can tie up billions of Euros. Finding the right trade-off on those numbers is ultimately a political decision that we cannot simply delegate to insurance supervisors.

The second way to boost insurance companies’ ability to promote long-term investments is by reducing operational complexity and operational burdens, particularly for those insurance companies that are smaller and have a low risk-profile. For those companies, a “longer leash” can be justified. The European legislator has already introduced such a regime for smaller and less complex banks in a recent revision of the Capital Requirements Directive. Such an approach can serve as a blueprint for the insurance world and the European Commission has indeed picked up on the idea by introducing a new category of low-risk insurance undertaking.

Insurance regulation is overdue for a healthy dose of proportionality. A “one-size fits all” approach is usually very convenient for the supervisory authority, but it is not for the supervised entities, particularly for the smaller ones. The Commission proposal is a decent starting point that should be further refined in the legislative process.

Of course, only because there is now a distinct class of insurance companies that is classified as low-risk does not mean that we are done with reducing regulatory burden. Many of the reporting requirements in Solvency II are quite burdensome and often of little use to a wider audience. Rather than slimming it down, the Commission proposal would even further extend those more problematic reporting requirements.

When revising the Solvency II framework, we should be mindful that we already have a good system in place that is considered by many as the international gold standard for insurance regulation. Therefore, what we need is not a grand overhaul of Solvency II, but a few targeted changes in order to make it fit for the challenges in the upcoming decades. We can improve Solvency II, make our insurance industry more competitive and have it contribute to key policy initiatives without compromising on financial stability. We should make the most of this chance.

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Solvency II review: main aims, topics for negotiation and remaining challenges

Solvency II established a framework for supervision of Europe's insurance sector, underpinning the importance of a risk-based approach to assessing and mitigating risks. With the overarching objective of strengthening policyholder protection, the framework continues to work well. Nonetheless, it is important that the recent review concludes in a timely manner so that the regime remains fit for purpose, in particular given the current economic situation.

Overall, EIOPA is happy with the progress of the review, with all parties involved – the European Commission, the Council and the European Parliament – largely following the same objectives as those that EIOPA proposed: To target an evolution rather than a revolution and to recognize the economic situation and complete the regulatory toolbox with macro prudential tools and recovery and resolution measures.

Furthermore the Commission's proposal for a Insurance Recovery and Resolution Directive, is to be welcomed. The ultimate goal is always to prevent failure or – if this is not possible – faciliatate an orderly market exit. The Commission's proposal, which follows closely EIOPA's technical advice, focusses very much on the preventive approach, addresses all relevant building blocks of a recovery and resolution framework, and also focusses on cooperation and coordination among authorities.

> **Target an evolution rather than a revolution, recognize the economic situation and complete the regulatory toolbox.**

One areas area that remains of some concern – and where current proposals have moved away from EIOPA's Opinion relates to proposed relaxations in the valuation of liabilities and capital requirements that have the potential to endanger the well-functioning of the regime, thereby generating an undue capital relief again at the cost of weakening the protection of policyholders. In this regard, the measures included in EIOPA's Opinion have been designed specifically with the long-term nature of the insurance business and consumer protection in mind:

- The review of the extrapolation is key to make the liabilities realistic, improve incentives to risk management and thus ensure that insurers will be able to pay future claims.
- The Risk Margin is a consumer protection measure to ensure undertakings can transfer their liabilities to another undertaking without impacting the insurer's future benefits. Revision of the risk margin can be introduced in order to recognize diversification over time thereby reducing size and volatility of the margin, especially for long-term liabilities. But the calibration should remain prudent, indeed a too high decrease the Risk Margin value would be unjustified and harming policyholder protection.
- The revisions to the Volatility Adjustment are introduced as a consistent set of measures, in order to enhance its efficiency as a countercyclical adjustment. In particular, there can be a more favourable but prudent treatment of insurers' long-term liabilities compared to those of shorter duration.

Further, there are technical arguments for the Solvency II Directive to address sustainability explicitly. The analysis on the prudential treatment of insurers' activities associated with sustainability factors requires a strong legal basis, as does the requirement for proper climate risk assessment by the undertakings in their ORSA. This is intended to reinforce the risk based and evidence-based nature of the analysis.

Besides the topics mentioned above, EIOPA stresses that the SII review is a good opportunity to address tdiversity on board of insurers. There are existing provisions for management boards of banks and there should be in the same manner for insurers.

EIOPA also considers the review of Solvency II an opportune moment to include a targeted amendment regarding individual disclosures in the context of EU-wide stress test exercises. To that end, in April 2022, EIOPA published an Opinion to the European Institutions to recommend a consistent and disciplined communication of individual stress test results to enhance market discipline, increase stress test participants' commitment and contribute to a level playing field among insurers and across the financial sector.

It is in everyone's interest that discussion progress well and that the new Directive enters into force as early as possible. This is to the benefit of both the sector and policyholders. The very technical nature of some elements of the review deserve precise scientific treatment including reliable impact assessments and EIOPA – as a technical supervisory body – stands ready to support the co-legislators during the process of Trilogues and finalization of the texts in good time.

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Is a more uncertain world uninsurable? Making the Solvency II framework fit for the future

Unpredictable is the key word to define the world we live in as we are witnessing multiple large-scale crisis, coming from climate change and environmental degradation; the rise of global pandemics, cyber-attacks, or the economic consequences of ramping inflation and interest rates.

The current review of the Solvency II Directive has no choice but to take into account this uncertain and challenging context. European regulators and supervisors have to ask themselves how to trigger the right incentives and amend the various pillars of the Solvency II framework for, on the one hand, financial stability of the insurance sector and on the other hand, the unlocking of its full potential, within the EU and abroad, to support the twin transitions, to a more digital and more sustainable economy.

This challenging equation mirrors the current challenges of the insurance sector, which despite a high level of capitalisation, was unable to cover policyholders against the many consequences of the Covid 19 pandemic.

The Solvency II framework has proven its value in ensuring the strength of the insurance sector after the financial crisis but needs to be updated to become fit for the future.

In practice, this means a threefold legislative framework:

- Risk-based, coherent and simplified when needed, with the right articulation between the principles included in the Directive and the technical provisions of the Delegated Regulation;
- Enabling, to foster cross-border activities while protecting policyholders through a proper supervision at European and national level; and
- Forward-looking, to take stock of past crisis as well as new risks coming from a more digital or climate-vulnerable world.

> **This review is definitely our chance to make the Solvency II framework fit for the future and keeping it as a leading insurance regulation at the global level by building on and strengthening its core principles.**

As the outcome of a successful Solvency II review, we can expect the framework to reflect more accurately the risks of each insurance provider, based on a tailored analysis of their risk profile and the application of the proportionality principle. This should never compromise financial stability, a level playing field and consumer protection. It will also require a review of the technical provisions put in place to ensure a robust solvency of the insurance provider, taking into account the moving situation on interest rates, which requires to be ready to tweak and adapt the legal requirements as needed. Ensuring a proper funding of long term and sustainable objectives, through a fair and risk-based prudential treatment of equity investments, will be key.

We can also expect a better take on the cross border essence of insurance activities in a single market, to allow insurance activities and providers to be spread across markets and ensure equal access and protection for all European citizens. This means that European supervision and the role of EIOPA should be strengthened, although some competences might stay in the hands of national supervisors for the time being.

Last but not least, a legislative review is the perfect opportunity to update the Solvency II Directive against rising risks but also opportunities European insurers are facing. This is critical to address the protection gaps observed during the Covid pandemic or predictable in a world 2.7°C warmer in 2100 according to the IPCC 2021 report. These new risks should be cover like any other risks as part of a necessary and ambitious review of the Solvency II Directive. Insurers are not exempted from the need to take into account climate in their business and strategic decisions, should set up transition plans and put in place climate-related considerations in the selection of the members of their various internal governance bodies. Digital and cyber-related risks should not be forgotten and need to also become a key component of the insurers risk management processes, to strengthen their cyber resilience and progress on the coverage of cyber risks.

The Solvency II review, which is also accompanied by a new proposal for an insurance recovery and resolution framework, has therefore to strike the right balance between these equally important but sometimes conflicting priorities, for the benefit of policyholders and insurance providers, but more importantly, for the benefit of society as a whole. The current context and changing economic parameters should be an additional lens to consider to reach that objective, while building on the fundamental principles and specificities of the insurance business model and activities.

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Solvency II reform: making a proven approach fit for the future

My opinion is clear: overall, Solvency II has proven itself since it entered into force at the beginning of 2016. The risk-sensitive regulatory framework, based on principles and market values, has been helpful in enabling the early identification and better assessment of risks. At the same time, however, it has also shown some need for improvement in a few areas, which is not surprising in legal texts of this calibre. It was for good reason that a review was planned for Solvency II.

Europe-wide coordination of course requires compromise

The reform of a complex European regulatory framework such as Solvency II will make it necessary to balance many different interests, since the situation in Europe is very heterogeneous.

In the discussions regarding the Solvency II reform, we have always engaged in very intensive dialogue with supervisors of other European countries. This has enabled all of us to get an understanding of the special features of the various national insurance markets – and it has given us the chance to participate in formulating EIOPA's reform recommendation in many aspects. In the end, the compromise recommendation submitted by EIOPA was one we at BaFin supported, though we still saw some need for improvement in some points.

The right approach: evolution, not revolution

When it comes to the quantitative requirements, the assessment of long-term guarantees and the associated risks takes on a key role. Here, it is important to adjust the economic perspective of Solvency II such that the framework takes the long-term character of these guarantees into account.

A reduction of supervisory requirements could damage the foundations of Solvency II.

In introducing Solvency II, the EU introduced the extrapolation of the interest rate term structure, the volatility adjustment and the transitional measures – instruments that serve to implement such adjustments. EIOPA subjected these instruments to a comprehensive examination in the Solvency II review. It confirmed the transitional measures and recommended targeted improvements for the extrapolation and the volatility adjustment, in line with the idea of "evolution, not revolution". The extrapolation involves a new procedure that is to entail a moderate increase in the amount of market information considered but continue to ensure an adequate level of stability. The volatility adjustment is expected to have a significantly larger impact while taking the insurer's risk profile better into account.

From a technical point of view, this is a move in the right direction. It will be essential, however, to ensure that the new regulations are also manageable for the industry. To this end, we need to strike a balance between old and new requirements.

Reducing supervisory requirements would send the wrong signal

The recommendations of the Council and the Commission have addressed this aspect and struck a significantly better balance by making adjustments to the EIOPA recommendations. This is a positive development. But while relief measures are already being implemented, it would not be wise to go too far by satisfying additional demands, as the uncertainties and risks inherent in future developments are starting to become visible in light of the pandemic and the current geopolitical situation. Climate change, too, is becoming more and more evident. In light of all this, a reduction of supervisory requirements would send out the wrong signal and could damage the foundations of Solvency II: the adequate identification of risks. Such a step would jeopardise the protection of the policyholders and the stability of the financial markets – which are key objectives of solvency supervision. Trust in the Solvency II framework could erode, on a national and an international level. Nevertheless, the framework should provide for risk-adequate relief measures for small, non-complex insurers. This would strengthen the principle of proportionality and promote a more uniform approach for dealing with undertakings whose risk profile calls for simpler solutions.

European legal framework – in international demand

Today, we see Solvency II also setting standards beyond Europe's borders. Several countries already have similar supervisory regimes that are based on market-consistent assessments, or are currently in the process of developing such regimes. Examples include China, Japan, South Korea and Mexico.

At the global level, the International Association of Insurance Supervisors is developing an Insurance Capital Standard (ICS) – based on principles that resemble those of Solvency II. The ICS is intended to serve as an indicator of capital adequacy for Internationally Active Insurance Groups. Its key objectives are to create a level playing field and make international convergence a reality; significant progress has already been made in this respect. A five-year monitoring period commenced in 2020; once this period is over, a decision will be taken concerning the ICS and the form it might take. In Europe, Solvency II is currently considered a suitable implementation of the ICS.

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Solvency II: finding the right settings for a more balanced review

Slowly, the institutional procedure for reviewing the Solvency II directive moves forward. On June 17th, the Council of the European Union has agreed on its position on updated rules for insurance companies. Nonetheless, the position remains largely based on the European Commission's proposal and does not integrate the fundamental issues that will make the review a balanced one or not in terms of capital charges, volatility and long-term investment. The Council has opted for a compromise which represents more of a status quo compared to the Commission's proposals; the core of the review remaining in level 2 negotiations.

On the other side, the European Parliament (the ECON committee in particular) shows willingness to enhance the Commission's proposal before the future trilogues. If the Parliament's position is quite far from being decided, the Ferber's report is a step in the right direction for supporting the role of insurers in Europe's current and future economy (for instance, thanks to the reduction of the lambda factor for calculating the risk margin and of the cost of capital to 4%). Indeed, MEPs have more room for manoeuver than member states when it comes to differ from the Commission's proposal and to adjust the review in favour of a less volatile solvency ratio, pro long-term investments and capital-neutral prudential regime.

The reduction of the volatility of the solvency ratio should be an overarching objective for the legislators. Excessive volatility drive insurers towards countermeasures such as taking fewer risks in their asset portfolios, for example by limiting their exposure to the equity market.

Because of the current pro-cyclic nature of Solvency II, the recent sharp increase of interest rates carries disproportionate prudential effects. Counter-cyclical tools are essential and the coming months will be decisive. On that matter, we welcome the Commission's proposals on the volatility adjustment (VA), which increase the effectiveness of the VA in mitigating artificial volatility, with the exception of a proposed change to the "Risk Correction", which undermine the effectiveness in reducing pro-cyclicality. Indeed, the VA is key for stabilising insurers' balance sheet. More generally, countercyclical measures should be as effective in increasing as in decreasing interest rate environments.

Favouring LTEI is a positive political gesture but also a recognition of the insurers' DNA.

Although the European Commission announced last year a 90bn€ release in capital charges on the short term, it estimates that capital requirements should return to a level which is similar to the status quo at the end of the transition period, in 2032,. However, national impact analyses in France indicate even an increase of capital requirements and a deterioration of the Solvency positions on the long term, which contradicts the Commission's declarations and the EU's ambition of a financial sector that serves even more the Europeans. Let us recall that the direct effect of strengthening the interest rate shock would be to increase significantly the overall capital charge. Then, we reaffirm our advocacy for a review that is, at worst, neutral in capital charge.

Most of the Solvency II review will be decided next year, during trilogues and discussions over level 2 measures. It is especially true for long-term equity investments (LTEI), although perfectly in line with the EU's aim to finance its environmental and digital transitions, but whose eligibility criteria are unworkable as they stand. Favouring LTEI is a positive political gesture but also a recognition of the insurers' DNA as business actors who manage long-term investments. In this regard, some Member States proposed a few months ago a risk-based solution that introduces a liquidity test to justify a reduction in capital charges. Much work remains on LTEI, otherwise the review will not live up to its ambitions.

A balanced review is of utmost important to enable insurers to invest more in infrastructure and the economy. In parallel, the entry into force of accounting norm IFRS 17 in January 2023 puts an end to the overlay period of IFRS 9. This will create more artificial volatility of insurers' results, which may lead to a massive reduction of their exposure to the equity market towards safer investments as early as the end of 2022. Furthermore, the increase of interest rates could drive parts of private savings from equity markets to bonds, safer but less contributing to the funding of EU's economy.

To conclude, we pledge for an evolution of the prudential standard with substantial changes to balance the newly designed interest rate shock, so that Solvency II becomes a framework that guarantees financial stability but also reduces volatility and enables insurers to take a greater share in funding EU's major challenges.

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Solvency II reform – EU against the UK or different routes to the same outcome?

Solvency II reform is not just one of the biggest reviews of the post-financial crisis regulatory regime, it is also an early test case for how far a post-Brexit UK financial services framework will end up differing from the EU when the reviews are happening at the same time. The evidence so far suggests that recognisably similar issues are being considered by both the EU and UK, alongside the significant tension between the overall resilience of the sector and the desire to increase productive investment.

As arguments continue between insurers, regulators, and policymakers in Brussels and London alike, it is easy to forget that six years on from its commencement, the Solvency II regime enjoys wide support as a regulatory framework. In the UK, the Government is not proposing fundamental change to the directive. This approach is supported by the UK insurance sector which has joined with its continental neighbours, through Insurance Europe, in arguing for some key improvements whilst retaining a risk-based capital framework that incorporates best practice in both risk and capital management.

Where tensions are showing in both the EU and UK, they are on topics that are no less important for being familiar:

- how best to remove barriers to investment in long-term productive assets that aid transition to a net-zero world and build the post COVID economic recovery;
- how to calculate the value of those long-term liabilities and the true investments risks; and
- how to streamline overly onerous regulatory procedures that damage global competitiveness?

The UK Government approach to these over-arching challenges has been to segment them. Thus, it has proposed reductions to the Risk Margin of up to 60-70% on a modified cost of capital basis, comparable to similar proposals from the EU. For the Matching Adjustment (MA), it has proposed widening asset eligibility and streamlining approval processes but agreed with the Prudential Regulation Authority (PRA) on the need for changes to the Fundamental Spread mechanism. Finally, the UK Government has backed PRA intentions to streamline reporting requirements and approval processes.

How far a post-Brexit UK financial services framework will end up differing from the EU.

The European Commission has likewise proposed a major reduction in the Risk Margin. However, it also proposes changes to the extrapolation methodology for the risk-free curve rate and the Volatility Adjustment as well as revised capital charges for interest rate risk and long-term equity risk. As the interest rate related changes will increase capital requirements substantially, the impact on aggregate capital requirements appears rather limited.

Taken with the parallel EU proposals on recovery and resolution which insurers argue 'cut and paste' inappropriate banking requirements, there is still a range of areas on which insurers need to convince European Parliament policymakers ahead of final decisions. At stake is the extent of the insurance sector's ability to help meet the EU's ambitions for the Green Deal, Capital Markets Union and post COVID recovery.

In the UK, the points of contention seem more narrowly focused. There is just about consensus between the PRA, UK Government and insurers on a reduction in the Risk Margin, but still disagreement on its impact on off-shoring of longevity risk and overall benefit to particular firms. There is also some agreement on process improvements that can be made to speed up internal model processes and improve decision-making on MA eligibility. However, the greatest disagreement remains on the MA itself and, in particular, how the Fundamental Spread (FS) mechanism works.

The original UK Government reform proposals did not moot any changes to the FS, but the PRA intervened to put the issue on the table last summer, asking large insurers to model major changes to the FS that many insurers believe more than offset any capital benefits from Risk Margin reform. Amid a backlash from insurers, the Government has now proposed a Credit Risk Premium (CRP) mechanism that would require relevant assets using the MA framework to carry extra capital for extra and unexpected default. Even at the lowest of the three levels proposed, insurers estimate this could add to their net capital position, remove incentives to invest in a wider range of assets and increase balance sheet exposure to market volatility.

In both the EU and UK, elected politicians will have to make the final judgements on the trade-offs and overall risk appetite. In both cases, the technical details and their application will matter more than the headline rhetoric. Regulators see a world of increasing risk while policymakers see the opportunity to use insurer capital more productively. Insurers want regulation that works in practice and better reflects their long-term business and investments.

Further compromises will be needed but there are no guarantees that all sides will emerge feeling satisfied with the outcomes.

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Cross-border Insurance in the Solvency II Review

Over the past few years there has been a growing discussion around cross-border insurance services within the EU. This is partly driven by certain failures of Freedom of Services (FoS) providers and partly by the perceived increased differences in supervisory practices after the implementation of the minimum-harmonization Insurance Distribution Directive. It is encouraging that, as part of the Solvency II review, there will be more formalized methods of communication among supervisors going forward as without it, the legitimacy of cross-border models may be undermined. This model works, as it already has for MetLife, and the proposed changes will settle the discussion so that cross-border businesses can develop and grow without the risk that the provision of insurance via FoS or Freedom of Establishment (FoE) will be hindered or obstructed by divergence or duplication of supervisory requirements.

EU institutions are keen to achieve increased availability of cross-border financial services. It is how the overall single market is meant to work. For insurance, this progress has been slower, not just because of divergent market characteristics, but because of a scepticism of cross-border business models. While there is still divergence in insurance markets around the EU, a coordinated structure of supervision can work, even with the differences. All stakeholders have an interest in ensuring that cross-border insurance provision is a legitimate model within the EU. An effective and coherent supervisory ecosystem can be created by clear and pro-active communication between the home supervisor, the host supervisor, and the insurance undertaking.

The model constructed for MetLife, which provides insurance services via FoE branches in ten EU countries from a subsidiary in an eleventh, has been very effective, with an active home supervisor regularly engaging with host supervisors and a robust annual College programme (with EIOPA often in attendance). This has been bolstered by direct communication between the company and the host supervisors and the participation of the home and branch staff in local market insurance discussions via industry and business associations. By keeping all three sides of the triangle (insurance undertaking, home supervisor, host supervisor) strong, this ecosystem can be developed in a way that ensures strong confidence with the cross-border provision of insurance services.

> **Reinforcement of transparency, supervisory cooperation, and pro-active company engagement with both supervisors will allow supervisors and companies to progress with their work without the concern that cross-border models pose additional risk.**

EIOPA can offer guidance or consultation, where and when needed, on consistency of supervisory practices and on College activities. EIOPA can observe and promulgate best practices and case studies in supervision. Their expertise, analysis, and push for supervisory convergence can reinforce the ecosystem developed by host and home authorities. The effort of all stakeholders working together will help reduce risk and improve the perception of these cross-border business models.

As noted above, one expectation of the current Solvency II review was some agreement and conclusion that enhanced supervisory cooperation would be able to allay concern about the provision of cross-border insurance services. The system outlined above exists under the current framework and, while it is understandable that this can be strengthened in some ways, the information sharing part of the model should be purposeful for the specific business being supervised and not increase or duplicate the information already being collected as part of normal supervision.

Reinforcement of transparency, supervisory cooperation, and pro-active company engagement with both supervisors will allow supervisors and companies to progress with their work without the concern that cross-border models pose additional risk. And this, in turn, will help the EU progress its plans to grow and develop the cross-border retail financial services, including insurance.