Solvency II revision: main expected outcomes and remaining challenges

1. The legislative process related to the revision of Solvency II and to the Insurance Recovery and Resolution Directive is underway and will converge under the Swedish Presidency

A public representative noted that the European Commission (EC) had presented its proposals for the Solvency II review and the Insurance Recovery and Resolution Directive (IRRD) in September 2021. Solvency is widely considered a success. IRRD came as a surprise for some people, so its impacts need discussion. The Council has its general approach and the Parliament will begin its first round of scheduled meetings in the following week.

1.1 Solvency II weathered several crises appropriately, but emerging risks require some adjustments to further reduce volatility, deepen equity investment and improve the reaction to the macroeconomic environment

A regulator stated that Solvency should be ready for new risks. After five years, a review of Solvency is useful. There have been several crises and Solvency did what was necessary. Sustainability risks are a new risk that should be included in this review. Considering the advice of the European Insurance and Occupational Pensions Authority (EIOPA) on long-term equity investments, a more favourable yet prudent approach will be possible. Volatility is still an issue with the volatility adjustment (VA), as well as the macroeconomic situation. The key will be ensuring balance. The green transition must be financed while remaining prudent. The primary goal of the framework is to ensure financial stability and consumer protection.

2. Solvency II revision: what is at stake?

2.1 Better balancing policyholders' protection and a further involvement of insurance in the long-term financing of the EU economy is essential and requires policy makers to dive into technical details without underplaying risk

An industry representative commented that it is generally accepted that Solvency II has performed well throughout recent stresses. There is a need for an honest discussion about the balance between policyholder protection and the need to release capital in Europe. There is a large pool of capital in the sector and matching those long-term liabilities with long-term assets makes sense. This was discussed under Solvency I. Solvency II took a more prudent approach initially. After political changes, increases in stability and transparency and standardisation of risk models, there is a suggestion that now is the time to recalibrate. Insurers can be part of the productive capital long-term solution instead of being regarded as a risk to be managed. The way that adjustments are calculated is critical. The VA or the fundamental spread mechanism and the matching adjustment are all terms that politicians would normally avoid. ECON will need to take this very seriously. Technical decisions need to be monitored. There has always been tension between the political objective of releasing capital versus the prudential need to keep policyholders safe. Investors have to be able to take some risk but the question is how to balance this.

A public representative indicated that, as co-legislator, they would outline the Renew group's position. The main political objectives of the review have to be understood at European scale before going into the technical details. The review must prioritise the interests of the policyholders and enable the insurers to operate in the EU single market and play a role in the economic recovery. Freeing up capital for investment is key, but the stability of the financial ecosystem within the EU must be preserved.

A regulator commented that, with current geopolitical pressure, inflation rates of 9% and interest rate increases, it is not the time to make a substantial capital release. If capital is released, dividends will increase, and that is not the purpose of a supervisory regime. Supervisors should be very careful. In answer to a question on the extent to which the regulator can intervene in the level of the dividend, a regulator noted that, during a discussion in Europe in the Covid period, they advocated for a risk-based, individual company approach. The question is whether the purpose of the Solvency regime is to protect customers or to increase dividends.

A regulator noted that sometimes there are changes after productive dialogues with industry, but the supervisor has very little power to block the dividend from going out. This is addressed in EIOPA's advice for Solvency II. In serious cases it would be good to be able to take action.

2.2 Reducing volatility is key to leveraging the huge potential of EU insurers to invest in the EU sustainability transition

An industry representative stated that Crédit Agricole Assurances, with €400 billion of assets, heavily invested in the transition through financing major infrastructure project (wind farms, solar plants...). Major insurers all over Europe are also investing in direct assets and this investment fits extremely well with Life insurers'

liabilities. Long-term investments and cash flows are needed. Customers are asking for these investments and providing these cashflows from asset liabilities is good. The industry is looking for long-term investments in the transition, so there is a case to invest the money that policy administrators are giving to the insurer. There is the strategy and also the technical discussion around the need to adjust. Overall capital should be reduced. When managing asset liability and deciding whether to invest in a particular investment, the volatility of Solvency II and how it will evolve is considered. The priority is to reduce the volatility of measurements. The proposal to increase the VA mechanism, reducing volatility and freeing up capital, is welcome.

In answer to a question about the impact of the proposals on volatility, such as the extrapolation and the changes to the risk correction, on supervisors' positions, a regulator explained that the EIOPA proposal not only considered where changes are needed for risk, but how to reduce the volatility in the system. EIOPA reviewed how to resolve overshooting or undershooting of the VA. Changes to the VA as proposed by EIOPA involve several steps, making additional changes to one or some of these steps could result in more volatility. In the ongoing negotiations volatility needs to be constantly monitored. Markets are volatile, but some of the volatility is also a result of the framework that, to a certain extent, can be improved.

With regard to VA, an industry representative noted that the industry has information on the real-life parameters. KPMG has done a large amount of modelling on the UK proposals, which are more on the matching adjustment than on volatility, which is not such a big issue for the UK. Inputs matter. The sector is far more sophisticated now than at the beginning of Solvency II. There is much more data. Insurers are much better at collecting and inputting parameters. The industry is an ally, not a foe. The industry has data that others do not. Using this for real-life scenario planning, rather than just theoretically, is important.

An industry representative agreed that the VA is an important subject because it can be changed and can reduce the volatility. There are two ways that the capital can be released. It can be dividends to the shareholder, but, if released in some formula through the VAs, the cost of holding equity can be reduced. As an insurer, investment could be longer term and better investments made. The technical discussion about the VA or about how calibration is done is not just capital from insurer to the shareholder but also the way the company is managed.

2.3 Solvency constraints should be made further proportional to undertakings' risk profile, reducing accordingly unnecessary complexity and severity

A public representative noted that an important novelty in the EC proposal for the Solvency II relief is the proportionality regime, and, in particular, the introduction of a new category of insurance undertakings with a low risk profile that can automatically profit from this relief.

An industry representative stated that sometimes proportionality is missing. In 2019, there was a proposal for long-term investment. In practice, it is extremely complex and only a small number of insurers use it. Solutions should be simple and operational.

A regulator commented that BaFin would support even more far-reaching proportionality measures, but the current approach is going in the right direction. There is now a clear benchmark for each country and company. The undertakings that can benefit from the most extensive proportionality measures are defined. Proportionality means reducing the complexity of requirements to what is risk adequate, not reducing what is considered burdensome by the industry. With respect to the specific risk embedded, details on the long-term guarantees, VA and provisional measures have to be proven to be relevant for stakeholders. This is about transparency and comparability, not proportionality. The industry in some countries is against the requirement to have an audited Solvency balance sheet. An audited balance sheet makes the system much more credible and reliable and should not be discarded in the name of proportionality.

A public representative noted that a second priority is streamlining the legislative framework. Careful reconsideration of insurance company concerns about the Directive is needed, based on risk and proportionality. Flexibility and a risk-based approach should be the guiding principles.

3. Improving supervision of cross-border operation is necessary

A public representative noted that the current Solvency framework is weak in its approach to insurance supervision. Cross-border cooperation of supervisory authorities has not yet worked effectively.

In answer to a question on how to foster convergence in the supervision of cross-border activity, a public representative stated that cross-border supervision must be forced. Cooperation and communication between home and host supervisors must be clarified and strengthened, while the role and the missions of the European supervisor are enhanced.

4. An undertaking operating throughout the EU requires appropriate supervisory arrangements as well as fluid and intense communication in order to make the host and home supervisors comfortable

An industry representative stated that their organisation, an insurance company with Europe-wide cross-border activities, has been a case study for Solvency II and cross-border supervision. After an acquisition in 2010, all subsidiaries purchased in Europe were converted into

cross-border branches of an insurance company in an EU member state. The speaker's organisation to some extent overcommunicated with supervisors. Businesses that were already present were converted overnight. The inherent risk of the business did not change, but there was a question around the residual risk. Standardisation introduced with Solvency II reduced the supervisors' perception of the residual risk. The legitimacy of the model is dependent on overcommunication, so all four corners of the ecosystem work with an active host supervisor as well as the home supervisor. There have been frequent checks with EIOPA.

5. Is Solvency II a global 'gold standard'?

A public representative queried why there should be deviation from Solvency II if it is the international gold standard and whether the UK's own Solvency II review would be the beginning of a new phase of intense regulatory competition between the UK and the EU.

An industry representative stated that the UK Solvency II review is very similar to that proposed by the EU, with debates on the balance between releasing capital and the prudential requirement. The risk-based model was developed in the UK and it will not deviate significantly from it. The UK led discussions on matching long-term liabilities with long-term assets in Solvency II in the Council and lost, so now is the time to reopen those discussions. The insurance sector has indicated that there is a safe mechanism to release the capital needed to match long-term liabilities and assets. This should not be considered only in the context of protection of the policyholder. The objectives of the UK will likely be similar to those of the EU. With regard to the matching adjustment, the Prudential Regulation Authority (PRA) considers that the fundamental spread is flawed and has a more sophisticated method of dealing with it. The supervisor and the supervised will discuss where the risk should be. Clear debate on objectives, such as risk appetite and the mechanism to release capital, is important. There is some scope to release capital in certain instances, but the framework requires discussion.

5.1 Due to local specificities, regulators in the US and Japan have different views than Europeans on sovereign risk, mark-to-market balance sheets or long-term liabilities, yet all jurisdictions are moving in the same direction

A public representative commented that it is helpful for politicians to broker a compromise between not increasing the dividends and releasing capital for investments. A delegation of ECON had gone to the United States in July, where there was not much appetite for Solvency.

An industry representative stated that it is difficult to take a consolidated view of the 54 insurance jurisdictions in the United States. Overall there is a lot of respect for Solvency II. Many countries around the world are looking to implement their own version of Solvency II. For 20 years the US has taken a different view on things such as the mark-to-market and long-term liabilities. Questions are being raised around some of the zero, the risk-free, around sovereign bonds. The group capital calculation is still being worked on, though there is progress in the Insurance Capital Standard (ICS), where the US favours the aggregation method as opposed to the full Solvency II. Everybody is moving in the same direction but there are different views based on individual markets. Japan has questions about long-term liabilities.

6. IRRD: Recovery and Resolution in the insurance world

A public representative noted that switching from MiFID to Solvency had demonstrated that the banking world and the insurance world are totally different. In the IRRD proposal there is an impression of applying the banking world approach to the insurance world, rather than addressing the insurance world.

A regulator noted that recovery and resolution for insurance is currently disharmonised in Europe. Minimum harmonisation, at least, is required. Resolution is needed because insurers can fail. There were 219 cases between 1999 and 2020. That did not change with Solvency II coming into force but it is not a major concern. Businesses can fail and as long as that is orderly it is fine.

6.1 Dedicated and proportionate arrangements that fit the insurance sector specificities, as well as domestic insurance specificities, are necessary

A public representative stated that the IRRD is a 'diamond on the golden ring' standard. With a clear increase in insurance failures since 2008, the need for an insurance resolution regime is not in question. The issue is identifying the ways and means. There was no amendment rejecting the IRRD proposal, so presumably every political group is conscious of the need to anticipate failure of insurance providers, especially in the cross-border context.

A regulator explained that the supervisor must first establish why resolution would be needed. The next step is to assess whether there is in deed a matter of failing or likely to fail and that there is no chance of recovery in the near future. If that is the case, either insolvency law comes into force or resolution. More information must be shared around what is meant by resolution for insurers and whether it is a one-on-one translation from the banking recovery directive. Some similarities however are logical, e.g. a crisis management group can be organised in the same way for a bank or an insurer, however insurance specific aspects of resolution will have to be different.

An industry representative noted that this is already partially implemented in some jurisdictions, but not in exactly the same terms in all markets. However, the risks of banks and insurers are extremely different and this should be considered when framing guidelines. An example is the frequency with which resolution plans are requested because insurers do not change as fast as banks. Insurance guarantee schemes (IGSs) are very

local. It is questionable whether these should be used in resolution. They are there for the customer. An IGS should be market by market, not European level.

Two industry representatives agreed that the 'diamond on the golden ring' expenses of IRRD would be passed on to the customer.

6.2 Harmonising the necessary means to protect policyholders is essential notably in a cross-border context

A regulator noted that the damages faced need to be considered. If there is an IGS and the policyholders can be protected, it might be acceptable to have a fund to finance the authority but not to organise a great deal more capital in a resolution fund. However, at the moment aa minimum, harmonisation of IGS is missing. This means that currently insurance products can be sold across the border, but, if a business fails, it depends on where the consumer buys the product as to whether they will be protected.

6.3 It is key that the teams in charge have insurance knowledge

A regulator noted that a liquidator dealing with an insurer is not specialised in insurance, it could also be dealing with a bakery or a shoe shop. Alternatively, a resolution authority could be someone who already knows the entity and knows what insurance is. Implications on whether you would want a liquidator or resolution authority to deal with the matter, will be depending on what kind of insurance it is, how big it is and how critical the function is. Another question is how to fund the authority and the directive, keeping in mind dat an authority could be a team of 10+ people in a resolution authority. The most important factor is that the team has insurance knowledge.

6.4 An appropriate and common assessment of insurers' specificities in different jurisdictions is necessary to avoid copy-pasting the banks resolution framework and defining the appropriate scope and ambition for the legislation

A public representative noted that there are a wide range of amendments addressing all the issues in the banking sector and not yet proposed in the insurance sector. In the banking sector, there is a deposit guarantee scheme. There are no standardised or even European-wide IGSs, but IRRD refers to them. There are amendments to create a Single Resolution Mechanism (SRM), which is available in the banking sector and not in the insurance sector.

A public representative commented that the framework must be tailored to the specificities of the insurance sector. The IRRD proposal excludes any additional capital changes for insurance providers, contrary to what exists in banks, and also foresees the establishment of an equivalent to the Single Resolution Fund. Questions include the scope of application, how meaningful criteria are set up with the right level of proportionality and the role of the resolution authority. Renew does not favour the creation of a new authority, but there must be a clear separation between resolution and supervisory tasks. All the options for financing resolution face political opposition because the purpose of the resolution framework is to avoid taxpayers contributing. Renew requested an impact assessment of potential harmonisation of European wide minimum standards for the schemes from EIOPA and the EC. This could lead to a legislative proposal, which could be a less intrusive policy option. There are IGSs for some insurance types in a number of member states, so more assessment could be requested.

A regulator commented that supervisors had been surprised by the proposal. A resolution is dealing with the insolvencies of legal entities and insolvency law is still national law. Whether there is a critical function in insurance should be analysed. Historically, there have seldom been cases where the supervisory mechanism in the Solvency regime would not have been sufficient. The process should be risk based, taking into account the ability to fund the resolution, possibly through a national IGS. In Germany, there are two lines of business and a well functioning IGS, so the German market has a totally different view to other markets.

A regulator stated EIOPA would be happy to work on a request for technical advice for an IGS once such a request was received. Harmony is limited and supervisors need to discuss this.

6.5 The positions within the Parliament are not yet stabilised

A public representative commented that it is premature to talk about political differences. Informal discussions will start in the current week, so there will be more understanding of political differences in a few weeks. There will be some divergences, but many convergences as well.

A public representative added that normally the European Parliament does its work, the Council does its work, then the two meet. The starting point is that the Parliament amendments are discussed, not the general approach. That will be for the trialogue. It is not yet possible to identify differences as Parliament's starting position is not known.