SOLVENCY II

Seizing the opportunity

The review of Solvency II can deliver benefits for policyholders and contribute to EU objectives, including global competitiveness

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The EU, including its insurers, has had to deal with serious economic and societal challenges recently, such as a period of low and negative interest rates, several natural catastrophes, the COVID-19 pandemic, the war in Ukraine and now a period of very high inflation. During each of these events, Solvency II — the EU's comprehensive, risk-based prudential framework — has demonstrated that European policyholders remain very well protected. At the same time, the framework has enabled supervisors to effectively monitor both individual insurance companies and the industry as a whole.

While the European insurance industry is a firm supporter of Solvency II, there is a need for a number of improvements to avoid unnecessary impacts on consumers, barriers to insurers investing in Europe's sustainable transformation, unnecessary costs and impediments to the ability of the industry to compete globally.

The current Solvency II review provides the opportunity to fix the technical flaws that are the source of these excessive requirements and to make the prudential framework future-proof and fit-for-purpose in an ever-changing world.

Where are we in the process?

After roughly three years of technical work and consultation, the European Commission published its proposals in the autumn of 2021. The proposals aimed to achieve several objectives, including incentivising insurers to invest more in long-term capital, taking better account of certain risks — including those related to the climate — and reducing insurers' sensitivity to short-term market fluctuations.

However, despite promising headlines, including a stated €90bn of aggregate capital relief for the industry, on closer inspection the Commission's proposals fall short of what is needed to achieve its objectives. In particular, the €90bn was only foreseen to be available in the short-term — whereas insurers' capital planning and investment strategies are long-term — and some of the proposals would create, rather than diminish, artificial solvency volatility and operational burdens.

Following the publication of the Commission's proposals, the Council of the EU developed and agreed its general approach under the French presidency in the first half of 2022, building on the work of the previous, Slovenian presidency.

While the French presidency did improve the Commission proposals by simplifying and clarifying certain aspects, overall Insurance Europe was disappointed with the lack of ambition. The Council's proposals do not include the justified changes that are needed to deliver a positive outcome for policyholders, companies and society in general and so represent a missed opportunity.

The development of the European Parliament position, under the rapporteurship of MEP Markus Ferber, has taken longer due to the diverging positions of the political groups. How to address concerns about capital and volatility and the appropriate way to integrate sustainability requirements for insurers have been a source of disagreement.

The current expectation is that the Parliament will agree on its position before the summer, allowing the trilogues to start in the second half of the year under the Spanish presidency.

> **“Improvements to Solvency II are needed to avoid unnecessary impacts on consumers, barriers to insurers investing in Europe’s sustainable transformation, unnecessary costs and impediments to the ability of the industry to compete globally.”**

Correcting the flaws and countering conservatism

Since the Solvency II framework was implemented in 2016, the industry has continually highlighted a number of technical flaws and embedded conservatism, which create excessive capital requirements and solvency volatility, particularly for long-term products.

Correcting these flaws would enable the insurance industry to increase its investment capacity while maintaining exceptionally high levels of policyholder protection. Increasing investment capacity would make it possible for European insurers to invest more in the transition to a sustainable economy. And increased investment returns would provide better outcomes for policyholders.

Every €1 of extra capital available to insurers can generate ...

€6 investment in green bonds

€3 if the capital charge for long-term equity is properly corrected

€6 investment in green bonds

€9 if the dynamic volatility adjustment is extended to the standard formula in combination with existing spread risk charges

€1000 in windstorm protection

Based on a simplified model of an insurance company and standard formula

The key areas in which changes to the current Solvency II regime are needed are:

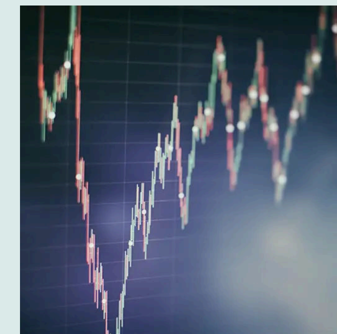
- The risk margin, which is an extra layer of capital insurers must hold on top of claims reserves and solvency capital. It is currently far too high and reduces the risk-taking capacity of the industry by around €140bn.
- The treatment of long-term equity holdings
- The volatility adjustment

These are all areas in which the Commission itself recognises that changes are needed and justified. On the risk margin and long-term equity, the Commission's proposals are a step in the right direction, but further improvements are justified and necessary if the review is to deliver its intended outcomes.

Preserving global success

European (re)insurers are an international success story. Over decades, they have expanded their presence and business both within Europe and beyond its borders, thereby offering insurance and protection to an ever-increasing number of policyholders. As a result, today the European (re)insurance industry is the world's most international (re)insurance sector; nearly half of all internationally active insurance groups are European.

However, Solvency II is putting this at risk and the end of provisional equivalence in multiple jurisdictions by the end of 2025 will add significantly to the competitive disadvantage. For example, an EU insurer offering business in the US under Solvency II may have to operate with 20–30% higher levels of capital, putting it at a considerable disadvantage in one of the world's largest markets.



How to avoid artificial solvency volatility

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Future proofing the prudential framework

Europe's insurers support the EU's ambitious sustainability agenda and are committed to continuing to contribute — building on their current actions — to the transition to a more sustainable society.

Changes to the Solvency II framework were made in 2019 to explicitly integrate sustainability requirements and the Commission's proposal includes a number of sensible suggestions to further enhance the framework in a coherent and risk-based manner. These are supported by the insurance industry and steps are already being taken to implement some of them.

In addition, Insurance Europe supports cross-sectoral initiatives, such as transition planning, which are foreseen to be required from a wide-variety of companies, including insurers, as part of the Directive on Corporate Sustainability Due Diligence and the Corporate Sustainability Reporting Directive (see article here).

However, it is crucial to maintain Solvency II as a risk-based prudential framework as its strengths lie in the fact that it is risk-based.

The proposals currently under discussion contain elements that go in the right direction but also others that can be improved or are counterproductive. This makes the review an opportunity still half missed. The hope is that the final rounds of discussions lead to further improvements that will benefit insurance customers and providers, as well as the economy as a whole.

How to avoid artificial solvency volatility

Mitigating excessive short-term solvency volatility was one of the key objectives of the Commission's Solvency II review — an objective shared by the industry. It is therefore disappointing that the Commission has chosen to propose changes that would unnecessarily increase solvency volatility.

Excessive short-term, or artificial, volatility is detrimental because it can increase the incentive to engage in procyclical investment behaviour and it creates disincentives for insurers to offer long-term products and guarantees and to invest long-term. It also typically requires insurers to put in place additional solvency buffers, which are otherwise not necessary, thus reducing the overall investment capacity of the industry.

The Commission's proposed alterations to the calculation of the **regulatory risk-free interest rates** increase the sensitivity of insurers' balance sheets to changes in the value of long-term swap contracts. This increases solvency volatility, as clearly demonstrated in the impact assessments of the European Insurance and Occupational Pensions Authority (EIOPA), and also creates an incentive to use more derivatives to manage this additional volatility. These negative impacts can be avoided if the calibration of a key parameter — the convergence parameter — is chosen wisely. For the euro, a 20% convergence parameter is considered appropriate and for non-euro currencies, the local market characteristics should be taken into account.

The Commission makes some very good proposals for much-needed improvements to the volatility adjustment (VA). However, the Commission has also made a proposal to change an element of the VA called the "**risk correction**" and this, if included in the review, would undermine the other improvements and add procyclicality into the VA, especially in a crisis period. The current risk correction is already conservatively calculated, has worked well and there is no evidence justifying a change. The risk correction is therefore one element that should not be changed.