

## Solvency II Review and Insurance Recovery & Resolution Directive (IRRDR)



### Introduction

The EU's Solvency II prudential framework has provided many of its intended benefits, including introducing a risk-based approach to solvency capital, setting very high standards for risk management and governance, and introducing extensive supervisory reporting and significant public reporting. As a result, the framework ensures very high levels of policyholder protection and a more level regulatory playing field across Europe.

However, the framework needs a number of improvements because it does not correctly reflect insurers' long-term business model, resulting in excessive capital burdens and solvency volatility for European insurers. It has also created a very significant, and in some cases unnecessary, operational burden for insurers.

These deficiencies result in negative impacts for consumers, both directly through increased costs and less optimal investments and indirectly due to reduced product availability and guarantees. They also constrain the insurance sector's ability to contribute to the EU's political priorities, including economic recovery from COVID-19, the Capital Markets Union (CMU) and the European Green Deal, as they reduce the sector's capacity to take risk. Finally, they undermine insurers' international competitiveness, their natural ability to take a long-term approach to products and investment and their ability to avoid procyclical behaviour during a crisis.

The review of Solvency II should not lead to a fundamental overhaul of the system. Instead, a limited number of focused improvements to the framework are needed that will, in aggregate, lead to a justified and needed reduction in capital requirements and volatility. The proposals of the European Commission (EC) for the Solvency II Review include some helpful elements that can be used as a basis for improvements. However, they also include other elements that would undermine these and some that would significantly increase the regulatory burden. These should not be taken forward or need more significant changes. The EC's proposals for a new Insurance Recovery and Resolution Directive (IRRDR) go beyond what is needed and also require significant changes.

The right changes to the EC proposals, as outlined below, will limit unjustified increases in regulatory burden and make the system more risk-based by better aligning it to the real risks faced by insurers. This will free up capacity for much needed investment, risk absorption and protection, while still keeping policyholders extremely safe. These corrections are necessary if the European insurance sector is to maintain its long-term business and product offering for the benefit of customers and financial stability, is to play its full role in the transition to a sustainable economy and other EU political objectives and is to compete internationally.

It is important that appropriate changes are made to both Level 1 and Level 2 of the current Solvency II framework, as both play a key role in determining insurers' capital and other requirements. In particular, elements that have a fundamental impact on capital requirements and resources should be specified in the Directive, for example the main extrapolation parameters. It is likewise very important that the impacts of changes are understood both at national level and European level to ensure that the objectives for the Review are achieved across Europe and unintended consequences at national level are avoided.

## Key industry recommendations for the Solvency II Review and IRRD

A number of important improvements are needed to the European Commission proposals in order for the Solvency II Review to:

- Deliver on the important European objectives set out in the Green Deal and the CMU, as well as support the Next Generation EU plans for the social and economic recovery of Europe.
- Remove unnecessary barriers to insurers' long-term business model, which provides benefits to customers and the wider economy.
- Support the competitiveness of the European industry on the global stage, and thus deliver on the EC ambition to strengthen Europe's leadership in the world.

| DO   | DON'T  |
|--|--|
| <ul style="list-style-type: none"><li>✔ Address existing flaws to better reflect the long-term nature of insurance business.</li><li>✔ Adjust EC proposals where necessary to reflect economic and market reality and the EU climate and investment needs.</li></ul> | <ul style="list-style-type: none"><li>✘ Do not change elements that work well, work well enough or where costs will outweigh the potential benefits.</li></ul> |

### 1 Correct the treatment of long-term business to address excessive capital and volatility

The following areas of improvements will help correct the excessive capital requirements and artificial volatility for long-term business by aligning the measurements with the real risks faced by insurers, while keeping customers very well protected.

#### Balance sheet-related measures

##### Extrapolation of risk-free rate curve

The EC's proposals for changing the extrapolation methodology need a significantly different calibration than the one proposed by EIOPA to avoid increasing the cost of providing long-term and guaranteed products to policyholders and increasing volatility.

The current extrapolation methodology already results in risk-free rates responding immediately to lowering interest rates, including when rates go negative. The current risk-free rate curves are already a conservative basis on which to value insurers' liabilities.

There is no technical justification for EIOPA's recommended calibration of the new extrapolation methodology. Their proposal would significantly lower risk-free curves, resulting in a substantial increase in the cost of providing long-term products and guarantees, as well as increasing the sensitivity of the framework to interest rate movements, creating additional solvency volatility, particularly for long-term business. The EC has not provided evidence that significantly reducing the projected long-term interest rates is needed or would benefit policyholders. EIOPA's regular stress-testing exercises, on the other hand, provide a further mechanism to assess concerns over low interest rates and have confirmed that insurers can cope not just with current low interest rates but even with far more extreme "low for long" interest-rate scenarios.

| DO   | DON'T  |
|--|--|
| <ul style="list-style-type: none"><li>✔ Set the convergence parameter to be at least 15% (and 70% for the Swedish krona).</li><li>✔ Include key extrapolation parameters, including the convergence parameter, in the Directive.</li></ul> | <ul style="list-style-type: none"><li>✘ Do not introduce changes to the risk-free rate curves that cannot be justified on a technical basis but would increase the cost of long-term products and increase volatility.</li></ul> |

## Volatility adjustment (VA)

The EC proposes a number of changes to the VA. With the exception of a proposed change to the “risk correction”, these are supported by the industry because, in aggregate, they better reflect the real economics of insurers’ balance sheets and increase the effectiveness of the VA in mitigating artificial volatility and procyclicality.

The EC’s proposal to apply EIOPA’s changes to the risk correction (one of the key elements of the VA calculation) should not be taken forward. The existing risk correction, based on sound economic principles, is already calibrated conservatively and has proven to work well in ensuring the impact of defaults and downgrades is adequately covered. Evidence justifying a change has not been put forward. On the contrary, changing the risk correction in the way proposed by EIOPA would undermine the other improvements to the VA and reduce their effectiveness in reducing procyclicality. Therefore, there should be no change to the risk correction or EIOPA’s proposal should be adjusted to minimise its adverse, procyclical effects.

The current requirement to publicly report solvency figures with and without the VA (and matching adjustment (MA)) should be removed. The VA and MA are key to correctly capturing the real economics and publishing both numbers creates confusion as to the valid solvency requirements.

| DO   | DON'T   |
|--|---|
| <ul style="list-style-type: none"><li>✔ Make material improvements to the VA, as proposed by the EC:<ul style="list-style-type: none"><li>● Increase the general application ratio to 85%</li><li>● Use an undiluted European reference portfolio</li><li>● Introduce a macro VA</li><li>● Include the overshooting ratio adjustment (CSSR)</li></ul></li><li>✔ Avoid the risk of confusion by removing the requirement to publicly report solvency with and without the long-term measures.</li></ul> | <ul style="list-style-type: none"><li>✘ Do not change the current risk correction methodology or add a liquidity adjustment factor.</li></ul> |

## Risk margin

The EC’s proposals to introduce a lambda parameter and reduce the cost of capital are welcome and needed because they help reduce the unnecessarily high costs of long-term liabilities and reduce volatility. Further improvements would also be justified.

The risk margin is an amount over and above the conservative valuation of the amount needed by insurers to cover all future projected liabilities, taxes and associated costs. It totals €160bn for the industry. As well as significantly reducing risk absorption and investment capacity, the current methodology introduces volatility because it is quite sensitive to interest rate changes. The changes proposed by the EC will help reduce its level and volatility, but further reductions would be economically justified, for instance to take more fully into account diversification or a lower cost of capital.

| DO   |
|--|
| <ul style="list-style-type: none"><li>✔ Significantly reduce the overall level and volatility of the risk margin through an appropriate combination of reducing the cost of capital, calibration of the proposed lambda, and allowing for group diversification. The EC proposals are a good step but further reductions are also justified.</li></ul> |

## Solvency Capital Requirement-related measures

### Solvency Capital Requirement (SCR) for investment assets

Solvency II capital charges for insurers investing in real assets such as equity, company debt and property do not correctly reflect the real economic risks faced by insurers — in particular because the framework generally and wrongly assumes that insurers are fully exposed to short-term market price volatility (trading risk) when, in reality, they are exposed to the lower risk of long-term underperformance of their investments. The Solvency II Review should address this.

#### DO

- ✔ For equity: Improve the current criteria for long-term equity category so that it works in practice and enables a significant portion of insurers' portfolios to be eligible for the more appropriate 22% capital charge.
- ✔ Make the symmetric adjustment to equity risk optional to avoid the risk that the EC proposal to widen the corridor creates, rather than mitigates, solvency volatility.
- ✔ For debt: Define a dynamic volatility adjustment to be allowed for the standard formula spread risk capital module.
- ✔ Maintain the current dynamic VA for internal model users without changes and new limitations such as those proposed in EIOPA's enhanced prudency principle.

### Interest rate risk

The EC proposals to better recognise low and negative interest rates in the SCR calculations are welcomed by the industry because they are consistent with how long-term interest rates (beyond the liquid part of the curve) will change under extreme downward interest-rate scenarios. However, a change is needed to the methodology/calibration to avoid excessive impacts on the liquid part of the curve. This will result in justifiable and appropriate increases in capital.

#### DO

- ✔ Use the extrapolation methodology to calculate the stresses for long-term interest rates, as proposed by the EC.
- ✔ Also improve the calibration/floor to avoid excessive impacts on the liquid part of the curve.
- ✔ Reduce the correlation parameter between interest rate and spread risk to 0.

## 2

### Improve proportionality and avoid increasing costs and operational burdens

Unnecessary operational costs and burdens created by Solvency II ultimately impact customers through higher costs and/or insurers dedicating less time to product development and other services. With the texts defining the Solvency II framework exceeding 3 500 pages, proportionality is vital to avoid unnecessary costs and burdens, but it is widely acknowledged that this is not working in practice. Furthermore, every reporting requirement — and in particular every change to reporting — creates the need for an IT project, data sourcing, validation and management processes by potentially thousands of insurers.

The EC has recognised the significant operational burden of Solvency II and has made some helpful proposals to reduce it, particularly for small insurers. However, these need to be improved if they are to work as intended and the EC makes other proposals that would create additional burdens. So, in aggregate, its proposals would lead to an overall increase in costs for the sector. Therefore improvements, including the following, are needed:

## Proportionality

The industry fully supports the introduction of the automatic application of proportionality. However, some improvements are needed to the EC proposals.

### DO

- ✔ Refine the EC's proposed criteria for low risk-profile undertakings and groups to avoid unnecessary exclusions.
- ✔ Improve the provisions for applying automatic proportionality on the grounds of non-materiality of risks/activities.

## Reporting

Increases in reporting arising from the Solvency II Review should be limited to those truly necessary and should be offset by improvements.

### DO

- ✔ Simplify the Solvency & Financial Condition Report in order to reduce, not increase, the workload. Therefore allow a report with focused, relevant information for policyholders and a simple dataset for other market participants (with no mandatory narrative).
- ✔ Remove the requirement to publicly report solvency with and without the long-term measures.

### DON'T

- ✘ Do not introduce a new external audit requirement set at European level.
- ✘ Do not impose new reporting and disclosure of standard formula figures for internal models. These are not necessary, create additional costs and risk undermining the purpose of the internal model.

## Group supervision

The EC proposals are far too extensive and changes should be limited to those where there is evidence that there is a real need and that the benefits outweigh the costs. The EC's proposals to change the requirements on group supervision and grant additional powers to the group supervisor in Solvency II go far beyond what is necessary.

### DO

- ✔ Accept the EC proposals to fix the trigger inversion issue.

### DON'T

- ✘ Do not make unnecessary changes to the existing legislation on group supervision or changes for which costs outweigh potential benefits.

## Recovery and resolution

The EC's proposals to implement a framework for recovery and resolution go beyond what is necessary given the extensive safeguards that are already in place to protect policyholders. Improvements to the EC proposals are needed to:

- Ensure the scope and requirements are appropriate and proportionate to the risks.
- Avoid unjustified new powers for EIOPA.
- Take fully into account the specific nature of insurers and avoid the simplistic application of banking requirements.
- Avoid gold-plating internationally agreed requirements.

| DO  | DON'T  |
|---|--|
| <ul style="list-style-type: none"> <li>✔ Implement a harmonised recovery and resolution regime that is reflective of the level of systemic risk and its specific characteristics in the insurance industry and respects internationally agreed standards.</li> <li>✔ Define a risk-based and proportionate scope of application to avoid unnecessary burden and costs for insurers.</li> <li>✔ Recognise the importance of cross-border cooperation and coordination between supervisory and/or resolution authorities within the European Economic Area and in third countries, as well as the mutual recognition of resolution actions.</li> <li>✔ Clearly define the roles, responsibilities and interactions between national supervisory authorities, resolution authorities and EIOPA.</li> </ul> | <ul style="list-style-type: none"> <li>✘ Do not apply a banking-style recovery and resolution regime to the insurance industry without considering insurance specifics.</li> </ul> |

### 3 Maintain the SCR as the starting point for the supervisory ladder of intervention

Solvency II was designed with two clear capital levels: the Minimum Capital Requirement (MCR — about €220bn for the industry) and the much higher Solvency Capital Requirement (SCR — about €610bn). This was done to create an early intervention point at which, as soon as the SCR is breached, the company is required to provide a recovery plan and the supervisor can intervene with a ladder of intervention measures, such as restricting dividends and new business. If the MCR is breached, supervisors can fully take over the company to either recover it or resolve it through a sale or run-off process. Above the SCR, the normal and ongoing supervisory dialogue applies and supervisors always have the power to enter into additional discussions with companies if they have concerns.

The key intervention points of the existing supervisory ladder of intervention should be maintained. Creating powers for new, even earlier intervention points, before the SCR is breached, is unnecessary and will indirectly increase capital requirements, potentially significantly, because insurers, supervisors and the market can consider the new intervention point as the implicit new solvency requirement.

#### Macroprudential measures

The EC's proposals to introduce new powers for supervisors to intervene before the SCR is breached are strongly opposed by the industry. The specifics of these powers should also not be delegated to EIOPA to design and calibrate. Other proposed macroprudential tools also go beyond what is necessary, given the limited level of systemic risk in the insurance industry, and add unnecessarily to the regulatory burden.

| DO   | DON'T   |
|--|---|
| <ul style="list-style-type: none"> <li>✔ Ensure a proportionate application of the EC's newly proposed macro-prudential tools in the ORSA and Prudent Person Principle.</li> </ul> | <ul style="list-style-type: none"> <li>✘ Do not create new, even earlier, intervention powers for supervisors before the SCR is breached, which would, in practice, increase capital.</li> <li>✘ Do not gold-plate internationally agreed requirements, eg with overly prescriptive and detailed requirements.</li> </ul> |

## Recovery and resolution

The intervention point for any resolution authority should be the MCR. If there is an insurance guarantee scheme, it should remain a protection of last resort, applying only once the point of insolvency has been reached and in accordance with its local statutes.

### DON'T

- ✘ Do not introduce new intervention powers for resolution authorities before the MCR is breached.

## 4 Other issues

### Sustainable finance

Insurance Europe supports sustainability, including climate-related risks, being integrated into Solvency II. While these risks are, to a very large extent, already covered, Insurance Europe recognises the EC proposals in this area are necessary developments:

- Increasing the frequency of recalibration of climate related natural catastrophe risks.
- Including climate stress testing within the ORSA.
- Giving a mandate to EIOPA to assess by 2023 if there is a risk-based justification for dedicated prudential treatment of exposures associated with environmental and/or social objectives.

### DO

- ✔ Ensure natcat risk charges reflect the changing climate by recalibrating parameters periodically and have companies include climate stress tests in their ORSA.
- ✔ Assess the need for differential treatment of green/brown assets based on real differences in risks.

### Cross-border supervision

Insurance Europe welcomes proposals to strengthen the cooperation between home and host supervisors around the activities of businesses operating cross-border through the freedom to provide services and the freedom of establishment (FOS/FOE).

However, changes should not compromise the home-state principle and improvements are needed to the EC proposals to ensure that:

- The changes are tailored to the specific problems they seek to solve and it is ultimately about ensuring that supervision is effective and the Solvency II framework is fully applied.
- The appropriate improvements will not result in overburdening or even discriminating against insurers whose business model integrates the opportunities created by the single market.

### DO

- ✔ Improve coherence and convergence in the supervision of cross-border activity and ensure information is shared between supervisors when needed.

### DON'T

- ✘ Do not introduce changes that compromise the home-state principle or create unnecessary costs and barriers for well-run cross-border businesses.

## Internal models

Internal models are a crucial feature of the Solvency II framework and are already subject to very extensive approval requirements and processes by national supervisors.

Care must be taken to avoid changes and new requirements that would increase the already high costs of developing and maintaining internal models or undermine their usefulness.

### DO

- ✔ Recognise the extensive and rigorous supervisory approval and reporting processes already in place and preserve (re)insurers' ability to reflect their own assessments of risks through the use of internal models.

### DON'T

- ✘ Do not make changes which can undermine or increase the costs of internal models without strong evidence of need.

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers pay out almost €1 000bn annually — or €2.7bn a day — in claims, directly employ nearly 950 000 people and invest over €10.4trn in the economy.