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## SOLVENCY II

# Safe and sound

### Solvency II can be improved while maintaining a high level of protection for consumers and the financial strength of the industry

The European insurance industry has a long history of strength, customer protection and advanced risk management. The EU's prudential regulation for insurers, Solvency II, was introduced in 2016 to create a modern, comprehensive, risk-based framework that matches the best practices in the industry and ensures harmonised, regulatory standards across the EU.

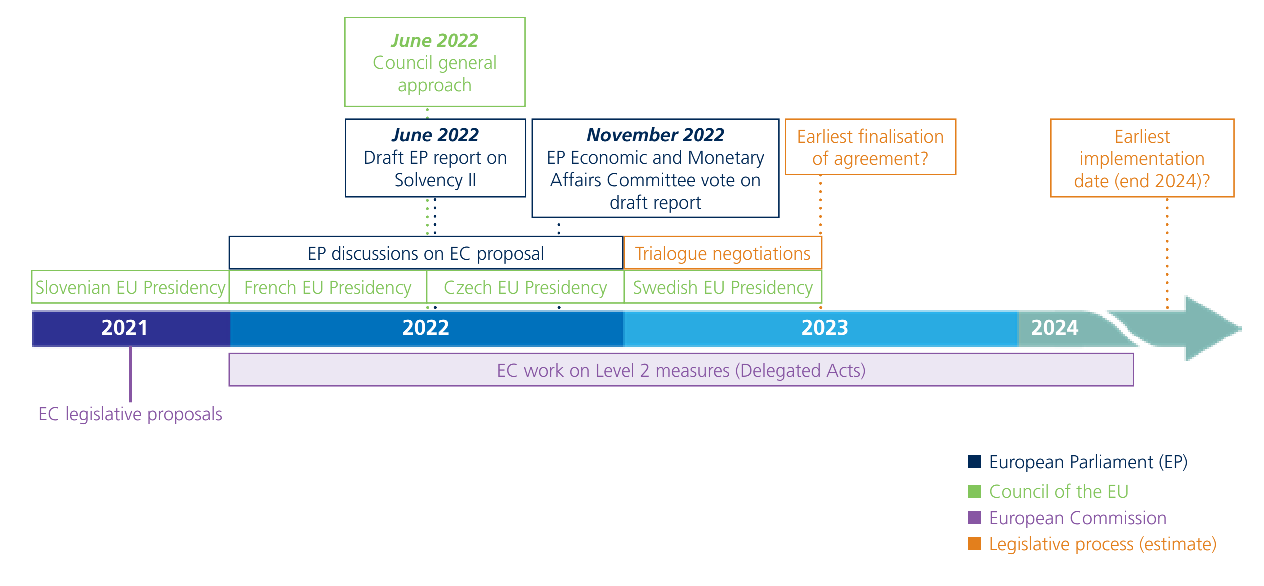
Solvency II has delivered many of those intended benefits, including exceptionally high standards of policyholder protection, risk management and governance, an economic risk-based approach to solvency capital and extensive supervisory and public reporting. There are elements of it, however, that need to be improved, in particular to remove barriers to long-term business and investment.

Given the wholesale and complex nature of the regulatory reform, this is not surprising. Indeed, a "five-year health check" was included in the Solvency II legislation to ensure the new regime works as intended.

Without harming policyholder protection, the insurance industry would like the current review to deliver on four core objectives:

- Enhance the industry's investment capacity
- Adjust the framework to properly embed sustainability
- Increase the operationality and improve proportionality
- Increase the industry's competitiveness within the EU and abroad while preserving policyholder protection

Timeline of the Solvency II review




When it published its proposals for the Solvency II review, the European Commission indicated that a capital reduction of around €90bn would help the insurance industry to support the transition to a sustainable and more digital economy, and to help fund post-pandemic economic recovery. However, the Commission's review proposals would deliver only a fraction of this, as while some of the changes proposed are indeed going in the right direction, some others would increase volatility and limit the needed positives to free up capacity for much-needed investment.

### Enhancing investment capacity

Collectively, Europe's insurers are its biggest institutional investor with over €10.6trn of assets under management. But how much it can invest and in what it can invest are impacted by the design of some measures in Solvency II that result in excessive capital requirements. This unnecessarily increases the cost of offering certain products and limits insurers' ability to invest in equities, corporate bonds and property.

Indeed, since Solvency II was introduced, extremely low interest rates and the rising costs of options and guarantees have pushed life insurers towards more shorter-term, less capital-intensive products. While this might be desirable to some extent to avoid excessive risk-taking, the framework should also acknowledge that offering long-term products with guarantees remains necessary, especially in member states where there is not a robust public retirement system. Solvency rules should not unnecessarily increase the cost of these products and lead to all the risk being shifted fully onto policyholders when the insurance industry could actually take it with the appropriate risk measurement. This would also reduce insurers' long-term liabilities and thus their need for long-term investments. And that shift towards short-term investing with the rest of the financial sector reduces insurers' traditional, stabilising role in times of financial turmoil.

### Embedding sustainability

The insurance industry has the capacity through its investments to help facilitate the transition towards a sustainable economy while meeting its commitments vis à vis its policyholders. European policymakers have been at the forefront of sustainable regulatory developments, with an unprecedented number of legislative initiatives. While we support the overarching goal, we believe that proposals from the review should aim to ensure that sustainability is adequately embedded into the Solvency II framework without bending any of its core principles.

Existing Solvency II requirements already take into account sustainability risks which must be considered in risk management, the own risk and solvency assessment

(ORSA), prudent person principle, underwriting, reserving and remuneration policy. They will soon be complemented by future sustainability reporting under the Corporate Sustainability Reporting Directive, the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation.

Therefore, going forward, it will be paramount for the balance of the framework that the outcome remains economically risk-based, especially when it comes to exploring the opportunity of a dedicated prudential treatment of exposure related to assets or activities associated substantially with environmental and/or social objectives.

### Improving operationality and proportionality

The average EU life insurer has to complete around 70 reporting templates containing about 150 000 individual data points. And this will only grow as ESG reporting increases. Is all this data really used? And does it really need to be collected from every company? The vibrant European insurance market is made of a wide variety of insurance providers, both large and small. It is to the benefit of consumers to maintain this diversity and avoid unnecessary reporting costs, which customers — ultimately — would bear.

The principle of proportionality was included in Solvency II in order to avoid unnecessary costs for companies and their customers. However, in practice it is widely accepted that proportionality is not working. The Commission has made some helpful proposals, in particular to introduce the concept of a low-risk-profile undertaking that would automatically be eligible for reduced regulatory requirements, but the Commission's proposals need refinements to make sure proportionality really works as intended.

### Increasing competitiveness and policyholder protection

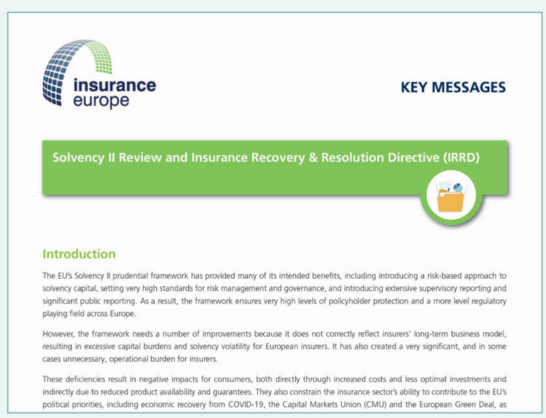
Policyholder protection is, rightly, the primary objective of the Solvency II framework and its capital requirements are based on a modern system of regular stress tests. These ensure that every European insurer has sufficient capital to cope with very extreme stresses — 1-in-200-year events — to protect policyholders. And, in reality, the vast majority of insurance companies set their own capital targets that are significantly above this level.

EIOPA's 2021 EU-wide stress-test exercise showed that the industry is even able to withstand a 1-in-1000-year event. It tested what would happen if the following all happened concurrently: a drop in interest rates to -1% until 2038; falls in equity markets of up to 45%; major disruptions in bond markets; higher than forecast claims; and 20% of customers allowing their policies to lapse. Even then, the industry would have had over €400bn more than it needed to pay all customer claims and meet its other liabilities. EIOPA's exercise also showed that liquidity was not a concern even under the very extreme scenario.

Protecting policyholders requires risks to be measured correctly to avoid excessive capital and volatility which, along with operational costs, can make products prohibitively expensive, restrict investment and innovative product design and impede European insurers' competitiveness on the international capital market, be it for external funding or external growth opportunity.

We are not advocating a race to the bottom but rather a levelling of regulatory standards in order to maintain EU insurers' competitiveness: excess capital, after all, comes with a cost. And even after the adjustments the industry is seeking, Solvency II would remain very much the global gold standard.

We believe that, overall, Solvency II has served its purpose since its implementation and that just a few targeted adjustments will provide an even more efficient framework. We trust that insurers, member states, the European Parliament and the European Commission will be able to strike the right balance which will allow us to reach our common ojectives.


insurance europe

KEY MESSAGES

Solvency II Review and Insurance Recovery & Resolution Directive (IRRD)

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

For more detail on Insurance Europe's positions on Solvency II see "Key messages: Solvency II review and Insurance Recovery & Resolution Directive (IRRD)".