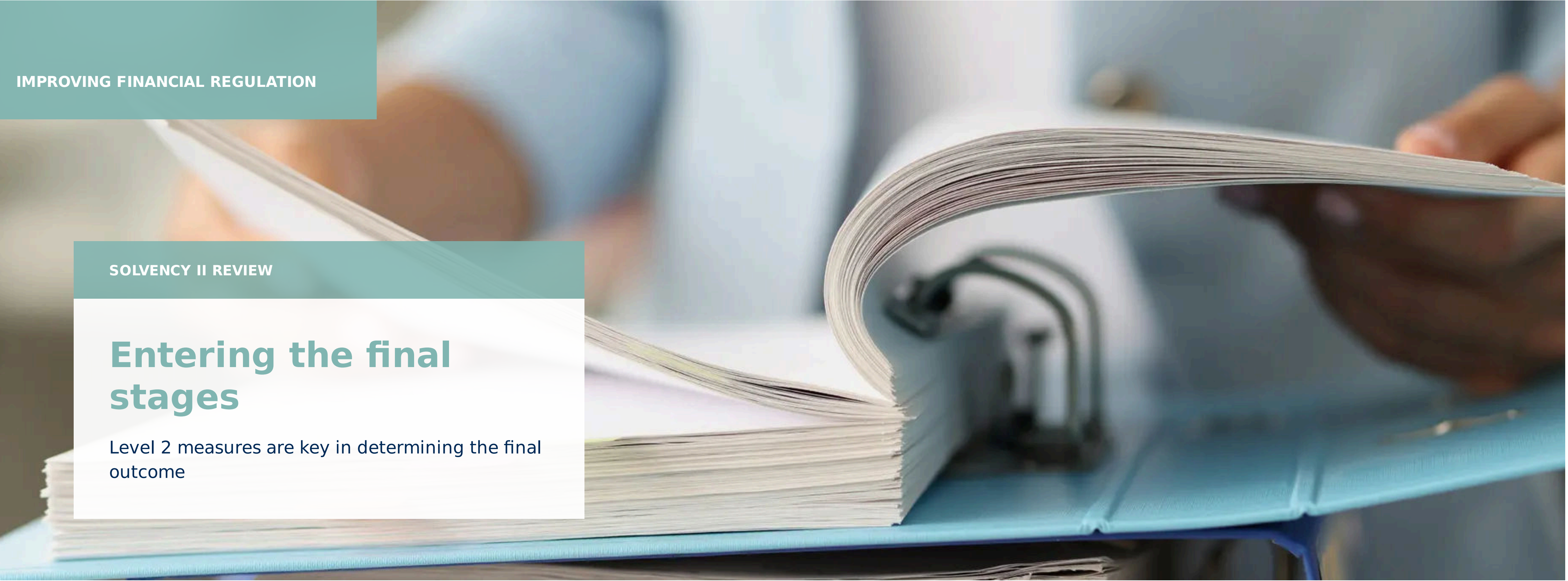

IMPROVING FINANCIAL REGULATION

SOLVENCY II REVIEW

Entering the final stages

Level 2 measures are key in determining the final outcome

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Delivery of the Directive

In December 2023, nearly five years after the Commission's original request for technical advice from EIOPA, the co-legislators found political agreement on the changes needed to update the Solvency II Directive.

As an industry, we welcome many of the agreed changes and also, importantly, the clear political steer that the co-legislators have given to the Commission to reduce excessive capital burdens and to minimise operational burdens when developing the more detailed Level 2 texts.

While the political agreement was reached in late 2023, formalisation and publication of the changes to the Directive in the EU's rule book, the Official Journal, is not currently expected until the fourth quarter of 2024 due to delays in the translation and legal review. This delay, in turn, means that the changes to the rules will not likely apply until late 2026, at the earliest.

From the industry's perspective, all stakeholders must work together to finalise the review and implement the changes within these latest timelines. Some of the changes will help the insurance sector contribute to the European policy objectives such as the Capital Markets Union (CMU) and the Green Deal. Others will reduce operational burdens for small and less risky insurers and address existing supervisory issues for cross-border business. Further delays in implementation delay the positive impacts that the changes will have.

Next phase of the review

However, that's not to say that the finalisation of the review is an easy task. While there has already been considerable work done to date (EIOPA's advice and supporting documents to the Commission in 2020 were well over 1 600 pages alone!), there remains a lot of technical work to be completed before companies can implement the rule changes.

This work will primarily be carried out by the Commission, who are tasked with updating the Level 2 Delegated Acts, and EIOPA, who have been asked to provide advice on 22 new legal instruments including technical standards, guidelines, and reports. In addition to this, EIOPA expects to have to review around 60 of its guidelines to ensure consistency with the new rules – a mammoth task.

From the industry's side, as well as providing input to EIOPA and the Commission, companies will also need to prepare to implement the changes. The extent of this work is not yet clear but given it will likely require some major modelling changes, updates to risk management processes and reporting systems, it could prove a significant and challenging task.

In light of this, we highlight the need for clear communication from legislators on the timelines and their expectations of companies.

Welcome…

As an industry, our key requests for the Solvency II review were for targeted changes which would result in:

1. improved treatment of long-term business, reducing excessive capital requirements and volatility and increasing the industry's risk-taking capacity;
2. better application of proportionality, to ensure the insurance market remains efficient and diversified;

3. reduced operational and reporting burdens for all insurers.

The updated Directive, if complemented by consistent changes in the Delegated Acts, will broadly deliver on the first two of our key requests.

Firstly, we expect that there will be a reduction in the currently excessive capital burden and volatility associated with long-term products. This is primarily due to the positive changes to the risk margin and some of the changes to the volatility adjustment.

Secondly, the higher thresholds for application of Solvency II and the reduced requirements for newly defined small and non-complex undertakings (SNCUs) will bring some welcome reliefs to smaller and less risky insurers.

In addition, there are several other areas where we consider the changes will overall improve the framework (even if they are not fully ideal). These include the new requirements to further integrate sustainability into Solvency II and additional provisions for insurers selling cross-border products.

... and unwelcome developments

However, overall, the review will bring increased operational and reporting requirements for the majority of European insurers. This is disappointing. Reducing the administrative burden by improving proportionality was one of the intended and shared objectives of industry, Commission, Council, and Parliament and it is now, more broadly, one of the Commission’s flagship initiatives.

When Solvency II was initially implemented in 2016, there were 89 unique annual solo reporting templates. Roll forward 8 years and we now have 98 unique annual solo templates to complete. During the last update alone, numerous changes were made and this comes on top of the increasing amount of sustainability disclosure requirements. And, we are not at the end yet, as substantial changes to insurers' Solvency and Financial Condition Report are expected as part of the Solvency II review compromise.

The review has also added significant new layers of requirements. These include short-term liquidity risk management plans (LRMP), sustainability risk plans, long-term climate scenarios in the own risk and solvency assessment (ORSA), audit requirements, additional internal model reporting as well as pre-emptive recovery plans (from the Insurance Recovery and Resolution directive (IRRD)).

At the same time, the review has done little to help reduce the mass of regulatory requirements that insurers face.

“Insurers welcome the clear political steer to reduce excessive capital and operational burdens.”

Finalising Solvency II v2.0

Given the huge amount of work the review has created (and will continue to create), it seems unlikely that there will be an appetite from any stakeholders for a comprehensive review of the framework any time soon. It is therefore imperative to get the Level 2 and Level 3 details right.

Safeguarding the long-term business model

One of the fundamental aims of the 2020 review was to assess and improve the “long-term guarantee” (LTG) measures. These are a package of measures, developed following the 2008 financial crisis, to mitigate the effects of artificial volatility and to better reflect key aspects of the insurer’s business model, such as asset-liability matching and long-term investment time horizons. Without these measures, long-term products such as pension products and worker’s compensation would be prohibitively expensive and likely unviable.

Through their changes in the Directive, the co-legislators have already made good progress in improving the LTG measures. These changes must now be complemented by appropriate technical calibrations at Level 2.

Volatility adjustment

- Avoid adding procyclicality to the framework, by designing and calibrating the risk correction parameters which provide a realistic assessment of the default and downgrade risk associated with the reference portfolio.

Risk margin

- Set the lambda parameter below a maximum of 0.975, without a floor.
- Allow for a risk margin that is either diversified or that is calculated at group level.

Extrapolation of long-term interest rates

- Set the convergence parameter to be at least 15% (and 70% for the Swedish krona (SEK)).
- Set the residual volume criterion above the existing 6% for the euro to ensure stability of the extrapolation.

Removing barriers to investment in European growth

One of the underlying assumptions of the Solvency II framework is that it assesses capital requirements on a one-year time horizon. This short-term time frame is inconsistent with insurers' long-term business model where assets are held for many years and even decades.

The capital requirements for long-term investment assets must therefore be designed and calibrated with this longer-term time horizon in mind. Otherwise, the capital required for some asset classes, such as equities, is too high and it deters insurers from investing in these assets.

In this context, the co-legislators' agreed improvements to the long-term equity category are welcome. Care should be taken to avoid that any supplementary requirements in the Level 2 reduce the effectiveness of the changes.

In addition, a further assessment of the capital charges for investment assets should be made to ensure that other unnecessary barriers are removed.

Long-term equity

- Don't introduce overly complicated or excessive conditions in the delegated acts which would restrict supervisors' ability to recognise equities as long-term.

Other investment assets

- Recalibrate the standard formula capital requirements for CMU-related assets, such as real estate and securitisations, to reflect the correct economic, long-term risks posed to insurers.

Tailored and proportionate requirements

Although the co-legislators did not deliver on making significant changes which would alleviate the excessive burdens for insurers, the next phase of the review offers the possibility for less fundamental changes which could reduce the existing and expected regulatory workloads for insurers and supervisors.

Some further extension of the proportionality measures agreed for small and non-complex undertakings to slightly less small and non-complex undertakings would provide some additional relief without new processes or frameworks.

Maintaining a truly risk-based scope and requirements for the reporting requirements is paramount to avoiding a regulatory overload which many insurers feel they are facing.

Proportionality

- Establish smooth transition rules for expected simplification during the transition period for entities exempted from Solvency II and SNCUs.
- Simplify approval procedures for non-SNCUs to access proportionality measures with clear criteria and target market share.
- Enable effective application of proportionality measures for SNCUs within groups.

Operational and reporting requirements

- Limit the scope of undertakings which will have to provide additional macroprudential analyses.
- Avoid overly prescriptive requirements for liquidity risk management plans and limit the scope of undertakings with additional requirements.
- For internal model users, ensure that the standard formula estimate is required in a manner that addresses the individual needs of the respective national competent authorities, independent from the regular supervisory report, and quarterly quantitative template processes.
- Streamline the solvency and financial condition report reporting burdens and do a future review of the necessity of the SFCR.

Sustainable change

Insurers are very supportive of the European Green Deal and the transition to a low-carbon economy. As an industry we are ready and willing to play our role. However, insurers alone cannot realise the transition. This is why horizontal legislation such as the Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CSDDD) have been developed and are supported by the insurance sector.

Solvency II was designed as a comprehensive risk management framework. This means that insurers are expected to consider all material risks, including sustainability risks, in their capital requirements and risk management.

As our understanding of climate change and other environmental, social, and governance (ESG) factors has improved, Solvency II has been updated to make consideration of sustainability risks more explicit. The changes made to the delegated regulation in 2022 and those now agreed by the co-legislators to the Directive are broadly welcomed by the industry.

However, maintaining Solvency II as a risk and evidence-based prudential framework should be non-negotiable. And, as noted recently by the European Systemic Risk Board, prudential policy should not be used to achieve broader policy objectives such as the transition to a low-carbon economy and the necessary adaptations to climate change.

Sustainability in Solvency II

- For the sustainability risk requirements to be developed, avoid creating overlaps and inconsistencies with other cross-sectoral regulation that can create confusion and unnecessary costs and operation burdens.
- Avoid excessive and complex requirements which go far beyond the risk management tools for transition risks which have already been established, e.g. ORSA climate change scenario analysis.