insurance europe

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# Solvency II Review key messages ahead of trilogues

## Summary

The insurance industry welcomes the Solvency II review, which aims to strengthen European insurers' contributions to the financing of economic recovery, to progress on the Capital Markets Union and to the channelling of funds to the European Green Deal.

To achieve these objectives, the review should address concerns about measurement flaws that result in excessive capital requirements and high volatility.

This would remove the unnecessary regulatory barriers to insurers offering the long-term products, guarantees and investments that customers want and need. It would also help to enhance insurers' capacity to invest and to safeguard European insurers' global competitiveness.

The review should also ensure that proportionality works in practice and minimise the burden of new requirements so that costs — which ultimately fall on customers — are minimised.

In view of the trilogue negotiations on Solvency II, the insurance industry wishes to highlight the key elements below.

**Addressing these would help to ensure that the framework is more conducive to long-term investment, is proportionate and better supports international competitiveness while still continuing to guarantee policyholder protection.**

### Key messages

1. Correct the treatment of long-term business to avoid underestimating available resources and exaggerating volatility.

2. Correct the treatment of long-term investment to avoid excessive capital requirements.

3. Improve proportionality and avoid increasing reporting, other costs and operational burdens.

4. Limit changes to those strictly necessary in the areas of group, cross-border and macroprudential supervision.

5. Do not introduce changes that would undermine fundamental aspects of Solvency II, including the use of internal models and the solvency capital requirement (SCR) as the first intervention point.

6. Incorporate specific risk- and evidence-based sustainability-related elements.

# 1 Correct the treatment of long-term business to avoid underestimating available resources and exaggerating volatility

## Risk margin

The risk margin is an extra amount of capital that is required to be held by all insurers over and above the amount actually needed to cover all benefits and claims, taxes and associated costs. It totals €140bn for the industry. This level of additional buffer is not necessary and reduces the industry's risk and investment capacity. The current methodology also introduces volatility because it makes an insurer's solvency position very sensitive to interest rate movements.

The European Commission's proposals to address this by introducing a lambda parameter and reducing the cost of capital parameter will help reduce the unnecessarily high costs of long-term liabilities and reduce volatility. However, as recognised by the European Parliament, further improvements beyond those proposed by the EC are also needed and justified.

### Recommendation — Article 77

Further reductions to the risk margin, beyond what has been proposed by the EC, are necessary and economically justified. These include a lower cost of capital, introduction of a suitable lambda parameter and recognition of diversification.

The industry welcomes and supports the European Parliament's proposals to reduce the cost of capital to 4.5%. In addition, the co-legislators should agree a calibration for the lambda parameter that, in conjunction with the changes to the cost of capital, would reduce the overall size and volatility of the risk margin by at least 50%.

## Volatility adjustment (VA)

In its preliminary work, the EC proposed the following changes to the VA mechanism which would make it more effective: increased general application ratio of 85%; use of undiluted European reference portfolios; and the introduction of a macro-VA and a durational overshooting ratio adjustment). These proposals were supported by the Council of the EU and the European Parliament and are also welcomed by the industry.

To ensure that the proposals are fully effective, it is essential that the "risk correction" parameter is not changed. The EC's proposed changes to the risk correction would unnecessarily increase procyclicality and artificial volatility, in particular in a crisis situation. The current "risk correction" has proven to work well and is already conservatively calibrated. Changing this parameter would undermine the other improvements proposed by the EC.

In their proposals, the Council and Parliament both propose to include an undertaking-specific adjustment, which aims to further reduce artificial volatility for some undertakings.

### Recommendation — Article 77d

The industry supports the Parliament's proposal to incorporate all the positive elements of the EC proposals on the VA, while maintaining the current "risk correction" methodology and calibration without any changes. This will ensure the effectiveness of the VA in mitigating artificial volatility and procyclicality.

Should a decision to introduce an undertaking-specific adjustment be taken during the trilogues, the industry has a preference for the Parliament's proposal rather than the Council's version.

## Extrapolation of risk-free rate curve

While the industry recognises the EC's intention to change the methodology used to derive long-term interest rates, this change should

### Recommendation — Article 77a

The industry supports the proposals made by the Parliament to include a minimum convergence parameter of 13% and to define a first smoothing point (FSP) for the euro of 20 years.

Given the potentially large and disruptive impact that the change to the new methodology could have (depending on the final calibration), an optional phasing-in mechanism should be foreseen.

## 2 Correct the treatment of long-term investment to avoid excessive capital requirements

be balanced against the detrimental impact it could have on the price and availability of long-term products and solvency volatility.

To avoid increasing the cost of providing long-term and guaranteed products and increasing volatility, a more appropriate calibration of the "convergence parameter" than the one initially proposed by the EC is needed. Specifically, the convergence parameter needs to be set at 15% or higher for the euro. The market characteristics of non-euro currencies should also be reflected when determining the starting point of the extrapolation and the convergence parameter. In particular for SEK, the convergence parameter should be around 70%.

Furthermore, the starting point of the extrapolation should be fixed and should reflect the liquidity of the investment markets that insurers use to hedge their risks.

Solvency II capital charges for insurers investing in real assets such as equity, company debt and property should correctly reflect the real economic risks faced by insurers. Currently this is not the case and the framework generally and wrongly assumes that insurers are fully exposed to short-term market price volatility. In reality, insurers are exposed to the significantly lower risk of corporate defaults and long-term underperformance of their investments. This is because insurers' business model gives them a great deal of flexibility, allowing them to decide whether to sell assets, when to sell assets and which assets to sell.

### Recommendation — Article 105a

The industry welcomes the Parliament's proposal to incorporate simplified and workable criteria in the Directive without being overly prescriptive. The long-term equity category must be improved so that it works in practice and enables a significant portion of insurers' portfolios to be eligible for the more appropriate 22% capital charge.

In addition, the Parliament's proposals to exclude unit-linked policies from the symmetric adjustment to equity risk is supported.

## Long-term equity and symmetric equity adjustment

A significant portion of insurers' equity investment should qualify for the 22% capital charge. Insurers are by nature long-term investors. The lower, 22%, capital charge better reflects the real underperformance risk faced by insurers. A lower capital charge will also facilitate greater equity investment and enable insurers to fully contribute to the EU's political objectives.

In addition, any changes to the symmetric equity adjustment must avoid creating artificial volatility. This includes EC's proposal to widen the corridor of the adjustment.

## Interest rate risk

The current methodology used to calculate the interest rate risk submodule does not reflect the risk that interest rates can become negative and it underestimates the risks in a low interest rate environment. The proposals made by the EC, supported by the Parliament, will result in appropriate future capital requirements for interest rate risk. Subject to the minor alterations proposed by the Parliament, these changes are supported by the industry, as they will correct the flaws in the current methodology.

The Parliament has proposed to improve the EC's original proposal through the inclusion of a term-dependent floor. It is economically



justified to assume that there is an effective lower bound to interest rates given that negative interest rates represent the destruction of value for investors and the Parliament's proposals is therefore justified.

### Recommendation – Article 111 (1) – proposal from EP.

The industry supports the Parliament proposals to specify that the interest rate risk calculations should be consistent with the Solvency II valuation approach, as defined in Article 77a, and to introduce a term-dependent floor on the calculations. The phasing-in of the new interest rate risk should, however, be optional.

## Proportionality

Proportionality is vital to avoid unnecessary costs and burdens. However, it is widely acknowledged that this is not working in practice. Therefore, the Solvency II review should ensure that the proportionality principle is actually working.

### Recommendation

The industry supports the Parliament's proposal to allow insurance undertakings qualifying for low risk profile undertaking (LRPU) status under Solvency II to be recognised as SMEs for the purposes of the Corporate Sustainability Reporting Directive (CSRD). Proportionality should be appropriately applied to the insurance sector in the context of the CSRD requirements as is the case for banks.

The Parliament's proposal to define captives as LRPUs by default is also strongly supported. However, its suggestions to exclude reinsurers from the LRPU category should not be taken forward.

While the industry supports LRPU criteria proposed by the EC, further refinements, such as to the non-traditional and size criteria and non-life insurance class 3 and the exclusion of nearly all cross-border activities, would be welcome to make proportionality work for all markets. In addition, it would be appropriate to include a clause on a planned review of the LRPU criteria.

### Recommendation

The industry supports the EC proposals limiting external audit requirement to balance sheets disclosed as part of the SFCR and exempting LRPU.

The extension of reporting deadlines proposed by the EC, as well as the extension of group deadlines proposed by the Council, are also supported. The industry highlights the need for an extension of the 5-week reporting deadline for the quarterly QRTs.

Finally, it would be a missed opportunity not to streamline the SFCR report. This could be achieved by limiting the part of the SFCR addressed to market participants to the public QRTs, without a mandatory narrative.

## 4 Limit changes to those strictly necessary in the areas of group, cross-border and macroprudential supervision

## Reporting

Increases in reporting arising from review should be limited to those truly necessary and should be more than offset by reductions. Every reporting requirement — and in particular every change to these requirements — creates the need for an IT project, data sourcing, validation and management processes by potentially thousands of insurers. Unnecessary operational costs and burdens ultimately impact customers through higher costs and/or insurers dedicating less time to product development and other services.

External audit requirements for the Solvency & Financial Condition Report (SFCR) will be very resource-intensive and entail significant costs for insurance companies — costs that will exceed the benefits. While the Parliament and Council proposals allow for an extension of the scope beyond the balance sheet disclosed as part of the SFCR, the EC proposals only request the audit of this element.

### Recommendation — Article 230/Art 212-213

The co-legislators should seek to remove double counting within the minimum consolidated group SCR by removing the inclusion of the notional MCR for holding companies, in line with the Council proposal. Furthermore, double counting caused by the extension of the group floor to non-EEA subsidiaries should also be addressed. In parallel, the industry supports the EC's proposal to address the trigger inversion issue.

Finally, while the industry supports the Parliament proposals on Art 212 on definitions and Art 213 regarding cases of group supervision, it cautions against further extensive changes in the area of group supervision.

## Group supervision

Changes to group supervision 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 are too extensive and go far beyond what is necessary.

There are issues regarding the scope and the calculation method of the minimum consolidated group SCR, which lead to trigger inversion and double counting. Regarding the calculation method of the minimum consolidated group SCR, the drafting of Article 230 (2) currently allows for a situation in which a group covers its SCR but faces an MCR breach (trigger inversion issue). Regarding the scope, the EC and Parliament's proposed extension of the scope to insurance holding companies and mixed financial holding companies leads to double counting, as does the EC/Parliament/Council proposed extension of the group floor to non-EEA subsidiaries.

### Recommendation

The industry supports the Parliament proposal to set up digital collaboration platforms for cases of significant cross-border activity with joint on-site inspections being conducted by the home national supervisory authority and powers for EIOPA to mediate should there be disagreements in the platform.

Further assessment of the definition of significant cross-border activities is needed during trilogues to ensure that the new measures are targeted at the problems being addressed. A combination of the undertaking-specific threshold proposed by the Parliament (15% of business of an insurer conducted in a specific market) and the discretion of national supervisory authorities proposed by the Council is advisable. In addition, reinsurance activity should be excluded because it is cross-border by nature and involves business-to-business transactions.

## Cross-border supervision

The industry welcomes proposals to strengthen the cooperation between home and host supervisors on the activities of businesses operating cross-border through the freedom to provide services and the freedom of establishment (FOS/FOE). The changes in this area should not compromise the home-state supervision principle and should be designed to minimise burdens for companies and supervisors.

## Macroprudential supervision

In their respective positions, the co-legislators all support the introduction of additional requirements related to macroprudential supervision.

Insurers' business models are significantly different to those of banks and other financial sectors. Differences include the fact that insurers are not interconnected in the same way as banks, their activities are highly substitutable, they are not at risk of failing "over the weekend" and they do not provide critical payment systems. In addition, the IAIS, with the help of EIOPA, has already developed an advanced framework for monitoring and mitigating global systemic risks from the insurance industry.

Insurers are not a significant source of systemic risk and, while some additional monitoring of systemic and liquidity risks could be justified, the co-legislators should avoid creating significant additional and unnecessary burdens.

## 5 Do not introduce changes that would undermine fundamental aspects of Solvency II, including the use of internal models and the solvency capital requirement (SCR) as the first intervention point

### Recommendation

The industry supports the Council's proposals to limit the scope of undertakings developing Liquidity Risk Management Plans (LRMP) and that the new power to remedy perceived liquidity vulnerabilities (Art 144b) should only be applied as a last resort and should not introduce the suspension of dividends, share buybacks and variable remuneration as a tool to address liquidity risks.

The industry also supports the Council's proposal to reduce the scope of macroprudential considerations in the ORSA and the Prudent Person Principle (PPP).

### Recommendation

The industry is supportive of the Parliament's proposed approach not to change the current reporting requirements for internal model users.

It is important to recognise the extensive and rigorous supervisory approval and reporting processes already in place and to preserve (re)insurers' ability to reflect their own assessments of risks through the use of internal models. In this respect, adding a requirement for internal model users to report regularly to supervisors an estimation of the SCR calculated with the standard formula would undermine the internal model and increase costs.

## Internal models

Internal models are fundamental to the Solvency II framework. They are developed to be reflective of the individual risk profile of the insurer and therefore allow risk to be measured more accurately. They are already subject to very extensive approval requirements conducted by national supervisory authorities. These are an integral part of companies' risk management and should not be undermined through inappropriate benchmarking or standardisation.

## Stress-test results

The purpose of the EIOPA stress-test exercise is to evaluate the potential for systemic risk that may be posed by insurance companies under situations of stress. Unlike EIOPA stress tests, banking stress tests are used to assess how current market and other assumptions impact a bank's financial position.

Solvency II already assesses individual solvency strength with an agreed and very extensive set of standardised stress tests, calibrated as 1-in-200-year events. These standardised stress tests set the capital requirements of all 3000 insurers in the scope of Solvency II). In contrast, EIOPA's stress tests only cover a limited number of companies (44 for the 2021 exercise) and test more extreme stress levels, calibrated as 1-in-1000-year events.

Insurers already publicly disclose substantial financial data about their individual solvency position, risks and sensitivities as part of their annual SFCR and other public reporting, providing consumers, investors and other stakeholders with the information needed to make

### Recommendation

The industry opposes the Parliament's proposal to give powers to publish the individual results of EU-wide stress tests.

This will lead to confusion about what the actual solvency requirements are and how these are related to the stress tests. It will also inevitably lead to the EIOPA stress tests implicitly setting additional capital requirements above those specified by Solvency II, as companies will be expected to "pass the stress-test exercises". In this respect, the industry is supportive of the EC and Council positions, which do not foresee such an obligation.

## 6 Incorporate specific risk- and evidence-based sustainability-related elements

## Recommendation

The insurance sector supports the following proposals by the EC:

- Regularly review — and update where necessary — the scope and the calibration of standard formula parameters pertaining to climate-related natural catastrophe risk.
- Introduce climate change scenario analysis into the Own Risk Self-Assessment (ORSA).
- Give EIOPA a mandate to investigate whether a differential prudential treatment for green/brown assets, as well as assets with a social objective, is justified based on the evidence of risk differentials.

While transition plans are supported for all sectors, it is essential to avoid overlaps and inconsistencies with other cross-sectoral regulation. Transition plans will be regulated by the CSRD/Corporate Sustainability Due Diligence Directive (CSDDD), potentially making their inclusion in Solvency II, as proposed by the Parliament, duplicative.

Differences in scope between the CSRD/CSDDD and Solvency II would have substantial (unintended) consequences with very limited added value.

Finally, the disclosure of individual climate change scenario analysis results in the SFCR should be avoided as it could lead to confusion. In this respect, the industry is supportive of the EC and Council positions, which do not foresee such an obligation.

a robust assessment of the insurer.

# Sustainability

Sustainability is a key element of the 2020 Solvency II review and its appropriate inclusion in the prudential framework will provide confidence and clarity that climate, environmental and wider sustainability risks are appropriately managed by insurers.

Although sustainability-related risks are already explicitly referred to in Solvency II, the industry recognises the benefit of adding some further details. It therefore supports suitable changes to Solvency II to incorporate specific sustainability-related elements that are risk- and evidence-based.



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