Belgian Financial Forum

SUPPORTED BY National Bank OF BELGIUM Eurosystem

The review of Solvency II

December 1st 2020

04.00 – 05.40 p.m. CET (Brussels time zone)

WEBINAR

Introduction: Jean HILGERS

Speakers:

Justin Wray, Head of Policy Department EIOPA

Hilde Vernaillen, President Assuralia; Director and Chairman of the Management Committee P&V

Didier Millerot, Head of Insurance & Pensions, European Commission

EIOPA's measures relating to the review of Solvency II

Belgian Financial Forum - webinar

Presenter: **Justin Wray**
Date: 1 December 2020

European Insurance and
Occupational Pensions Authority

The review of Solvency II was always foreseen

- The Solvency II Directive requires certain areas to be reviewed in 2020:
  - long term guarantees measures and measures on equity risk;
  - methods, assumptions and standard parameters used when calculating the Solvency Capital Requirement standard formula;
  - Member States' rules and supervisory authorities' practices regarding the calculation of the Minimum Capital Requirement
  - group supervision and capital management within a group of insurance or reinsurance undertakings.

EIOPA’s preference for the review is evolution not revolution because (1)

The risk-based three-pillar approach of Solvency II remains valid:

- First pillar: capital required against four principal risks: underwriting, market, credit, operational.
- Second pillar: insurers and reinsurers to have in place an effective risk management system.
- Third pillar: a harmonised system for disclosure and reporting

EIOPA's starting preference for the review is evolution not revolution because (2)

Implementation has largely been a success:

- Insurance industry has better aligned capital to the risks it runs;
- Risk-based approach to assess and mitigate risks.
- Significant strengthening of governance models and risk management capacity
- Insurers throughout Europe use harmonised templates for supervisory reporting, instead of a patchwork of national templates

2020 review of Solvency II

Call for Advice of the European Commission

Advice requested on …

- Long-term guarantees (LTG) measures
- Transitional measures
- Risk margin
- Capital Markets Union
- Dynamic volatility adjustment
- SCR standard formula
- Risk-mitigation techniques
- MCR
- Macro-prudential issues
- Recovery and resolution
- Insurance guarantee schemes
- FoS and FoE insurance
- Group supervision
- Reporting and disclosure
- Proportionality
- Best estimate
- Own funds
- Reducing reliance on external ratings

Deadline: 30 June 2020

EIOPA deliverables for 2020 review:

- Annual LTG reports 2016 to 2020
- Response to COM's Call for Information on asset-liability management
- **Opinion on 2020 review**

Objectives of the review

- Balanced updating of the current regulatory framework
- Proper recognition of the economic context
- Completion of the regulatory toolbox for insurance

Balanced updating

- Extrapolation of risk-free interest rates
- Risk margin
- Volatility adjustment (VA)
- Equity risk
- Proportionality

Completion of the regulatory toolbox

- Macroprudential policy
- Recovery and resolution
- Insurance guarantee schemes

Covid-19:EIOPA’s response: supervisory measures

Supervisory measures

- 17/03/2020: Statement on actions to mitigate the impact of Coronavirus/COVID-19 on the EU insurance sector covering issues related to business continuity and solvency and capital position
- 20/03/2020: Recommendations on supervisory flexibility regarding the deadline of supervisory reporting and public disclosure. Recommendations enable insurers to concentrate efforts on monitoring and assessing impact Coronavirus and are addressed to national competent authorities to help provide a consistent approach to supervision
- 3/04/2020: Solvency 2.4.0 Taxonomy - Technical specifications for EIOPA recommendations on supervisory flexibility regarding the deadline of supervisory reporting and public disclosure
- Extraordinary publication of Solvency II Relevant Risk Free Interest Rate Term Structures and Symmetric Adjustment to Equity Risk – now published on a weekly basis
- 30/04/2020 EIOPA revises its timetable for advice on Solvency II Review until end December 2020

Covid-19: EIOPA's response:Guidance for the insurance sector

- 2/04/2020: Statement on dividends distribution and remuneration practices recommending (re)insurers to temporarily suspend all discretionary dividend distributions and share buy backs aimed at remunerating shareholders.
- 01/04/2020: Call to action for insurers and intermediaries to mitigate the impact of Coronavirus/COVID-19 on consumers underlining the importance of access to and continuity of insurance services and outlining recommended actions for insurers and intermediaries to take

PROCESS AND TIMING OF THE REVIEW

Information request

Technical specification – General approach:

- EIOPA’s position on the review is not final.
- Sample: Representative sample of insurance and reinsurance undertakings with 50% market coverage, similar to the approach in earlier information requests for the review.
- That next to a baseline scenario (status quo) two scenarios are tested:
  - Scenario 1: all proposals with a material impact on the solvency position, and
  - Scenario 2: all those proposals but not the recalibration of interest rate risk.

Complementary information request

- Data on the combined impact of the advice, similar to the current information request but:
  - with a reference date of 30 June 2020,
  - simplified and restricted to the main proposals of the advice,
  - addressed to a subsample of that information request, consisting mainly of larger undertakings.
- Subject to the approval of EIOPA's Board
- Expected start date 1 July
- Expexted deadline 14 September 2020

Revised deadline for delivery of the advice

- Revised deadline end-December 2020
- Balance between need to use opportunity of reviewing Solvency II and need for advice to reflect recent developments
- Engage with all stakeholders in a transparent process

THANK YOU!

For more information visit:
https://www.eiopa.europa.eu

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The Review of Solvency II

Hilde Vernaillen
President Assuralia
1 December 2020

Assuralia

Strong Support for Solvency II

- **Risk-based framework for supervision**
- Total balance sheet approach
- Capital requirement aligned with companies' risk profile

- **Market consistent valuation**
- For almost all assets and technical provisions
- Risk free rate for discounting

- **Second and third pillar of the framework**
- With ORSA more focus on companies' risk management and governance up to the level of Board of directors
- Public disclosure

Shortcomings of Solvency II

- **Excessive volatility on the market consistent balance sheet**
  - Long term insurance portfolios are illiquid
  - Volatility Adjustment only partial solution, inappropriate for Belgian insurance companies

- **Strong disincentives for long term investments**
  - High capital requirements for corporate bonds and loans with long durations
  - A constraint for the long-term business

- **Excessive reporting**
  - Annual/quarterly reporting of *hundreds* of quantitative templates
  - *Dozens* of qualitative reports to the supervisor
  - Limited application of proportionality principle

1. A reliable measurement of the capital requirement

Based on the impact assessments of EIOPA:

- Useful **improvements to the Volatility Adjustment:**
  - Rescaling fixed income assets to be 100% of portfolio
  - Improving country component
  - Changing the general application ratio
  - Including a duration ratio adjustment in the application ratio

- **Unnecessary changes to the Volatility Adjustment**:
  - Changing the risk correction
  - Including an illiquidity adjustment factor in the application ratio

- How dealing with **excessive volatility?**
  - **Many alternatives but no solution on the table for Belgian insurers**
  - Proposed adaptations to the country component are not sufficient

2. An appropriate valuation of the liabilities

- **Review the design and calibration of the risk margin**
- Works procyclical in a low interest rate environment
- Increases the cost of provisioning LT insurance products
- Impact of proposed lambda factor is very limited
- A re-examination of the cost of capital percentage needed

- **Methodology to calculate the risk-free rates**
- No support for any changes
- The methodology reflects current low rates, even negative rates
- Modifications to the extrapolation method not warranted
- Need for a stable and predictable measure

3. Increase insurers' capacity to invest and take on risks

- **Long term investments in bonds and loans**
- Solution needed for heavy spread risk charges
- Improve insurers capacity to invest in sustainable projects
- Allow the use of the dynamic VA for standard formula users

- **Sustainable investments**
- No artificial incentives or disincentives based on green/brown criteria
- Capital requirements should be risk-based, i.e. reflect the real risks

- **Long term equity**
- Improvement of the qualifying criteria to support this asset class

4. A less burdensome framework

- **Reporting**
- Reduce the reporting templates to an efficient working level.
- Limit the introduction of new QRTs
- Avoid a large number of small changes to the existing QRTs

- **Proportionality**
- Legislation needs to ensure proportionality works in practice
- E.g. proportionality measures with pre-defined, risk-based criteria for their automatic application
- Requirements that are commensurate with the risk profile of smaller and medium-sized companies

5. A more efficient insurance market

- **Targeted legislation**
- Needs to fix real problems
- Proportionate application of supervisory tools

- **Macro-prudential measures**
- Harmonisation of some measures
- E.g. temporarily prohibiting redemption of policies in specific circumstances (for a specific company in distress)
- No new intervention powers before the SCR is breached
- No need for counter-cyclical capital buffers or capital surcharges for systemic risk

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2021 Solvency II review

What can we expect?

Belgian Financial Forum - 1 December 2020

Disclaimer

This presentation has not been adopted or endorsed by the European Commission. Any views expressed are those of the author of this presentation and may not in any circumstances be regarded as stating an official position of the Commission.

European Commission

Solvency II review – General context

- **Overall, a robust framework**…
  - Despite the Covid-19 crisis, insurers' levels of capital resources remain more than twice as high as what is required by the legislation
  - Therefore, no need to overhaul the framework: "evolution rather than revolution"
- **… Still a review is necessary…**
  - Legal background to review certain areas of the framework
  - Engagement with stakeholders revealed issues/shortcomings/gaps in the framework
- **… What is going to be reviewed?**
  - Specific architecture of Solvency II: a Directive + a comprehensive Delegated Regulation
  - Both will have to be reviewed in parallel

Solvency II review – a word on timing

- Covid-19 postponed the process by 6 months – EIOPA additional data collection
- EIOPA advice December 2020
- As indicated in CMU Action Plan (24 September 2020), Solvency II review scheduled for Q3 2021.
- Commission package: legislative proposals accompanied by Impact assessment. Amendments to the Directive and (possibly) separate proposal to introduce Insurance Guarantee Schemes framework. In parallel, discussions/consultations on changes to delegated regulation.

European Commission

Solvency II review - Consultation activities

Commission

- Public conference: 29/1/2020
- Inception impact assessment (roadmap) published on 1/7/2020
- Open public consultation 1/7/2020 – 21/10/2020

High reliance on the European Insurance and Occupational Pensions Authority's work

- Preparing technical advice for COM
- Consultation paper published in October 2019
- Data collections in autumn 2019, spring 2020 and summer 2020 for holistic impact assessment
- Submission of final advice in December 2020

Main themes to consider in the context of the Solvency II review

Solvency II review – main themes

Pending EIOPA’s advice and Commission’s final decision:

- Increase insurers’s contribution to invest in the long-term and finance the low-carbon economy;
- Enhance risk-sensitivity of the framework while tackling excessive volatility;
- Improve the application of the proportionnality principle;
- Improve supervision and policy-holder protection in case of insurer’s failure;
- Better tackle systemic risks faced by insurers.

Role of the insurance industry in the context of the CMU and the (forthcoming) Renewed Sustainable Finance Strategy

- **CMU: facilitating insurers' contribution to the long-term financing and "re-equitisation" of the European economy**
  - SCR = 99.5% VaR over a 1-year time horizon
  - Prudential rules are not main driver of investment in equity, but can still be one of the factors
  - Last year, COM introduced new preferential treatment for long-term investment in equities. But still limited use of the measure
  - Need to review the treatment of "**long-term equities**"

- **Green Deal: incentivising insurers to contribute to the "Green Transition"**
  - Climate change risks span over the long-term, and not a one-year time horizon
  - Debate: should we introduce differentiated capital treatments for green/brown assets ("**green-supporting / brown penalising factors**") and/or amend risk management requirements ("pillar 2")

Excessive volatility (1/2)

- **The market-valuation principle of Solvency II creates (possibly excessive) volatility…**
  - ➢ Can foster short-termism in insurers' underwriting & investment activities
  - ➢ Can result in a shift of the risk to policyholders
- **… Hence the need to review the volatility adjusment (VA)…**
  - ➢ VA aims to mitigate the impact of bond spread increases/crises on insurers' solvency position
    - ✓ Issues of "overshooting/undershooting" (covers "country VA")
    - ✓ No reflection of "illiquidity" of liabilities
    - ✓ "Risk correction" deficiencies

European Commission

Excessive volatility (2/2)

- **Symmetric adjustment on equity risk**
  - Currently modulates equity capital charge by up to +/- 10 percentage points
  - ESRB wants to enhance the countercyclical effect
- **Risk margin** (component of liabilities):
  - ➢ Deemed “too high” by the industry
  - ➢ Can be volatile for long-term business

Lack of risk sensitivity

- **Underestimation of capital requirements for interest rate risk**
  - Over the recent years, protracted environment of low and even negative interest rates
  - When initially designed, such conditions were not considered
  - Standard formula capital requirements do not reflect the risk of negative interest rates
  - Therefore, there is a potential underestimation of the risks insurers are facing
- **Inappropriate regulatory rates to be used when valuing long-term liabilities (extrapolation method)**
  - 100-year yield on AT AA-rated bonds (0.85%) was higher than the 65-year "regulatory spot rate" at issuance
  - EIOPA will propose to review the method to better reflect market data

European Commission

Proportionality and thresholds of exclusion from Solvency II

- **Solvency II is highly elaborated, but also very complex**
- **Thresholds of exclusion from Solvency II**
  - They have not been reviewed since 2009
- **Solvency II embeds an overarching principle of proportionality but it is quite abstract**
  - Lack of clarity / legal certainty from both supervisors and insurers
  - The effective implementation of the proportionality principle is not sufficient

Quality of supervision and policyholder protection in the case of an insurer’s failure

- **Inconsistent and insufficiently coordinated supervision of insurance companies and groups, including in relation to cross-border activities**
  - Lack of clarity in some areas leading to supervisory divergences with risks of regulatory arbitrage and unlevel-playing field
  - Recent failures of insurers mainly operating cross-border highlighted shortcomings in the quality/consistency of supervision and in cooperation between authorities
- **Unequal/incomplete protection of policyholders when their insurer fails:**
  - Harmonised toolkit and cross- border cooperation provisions are limited for recovery and absent for resolution to address insurers’ (near-)failures
  - Inconsistent or absent “safety nets” (insurance guarantee schemes) to protect policyholders when their insurer fails

Financial stability and systemic risks

- **Financial stability is also an explicit objective of Solvency II**
  - "Micro-prudential" supervision and risk-based capital requirements can contribute to disincentivising excessive risk-taking by insurers
  - Some regulatory tools also aim to avoid "procyclical" (herding) behaviours by insurers (e.g. fire-sale during market turmoil)
- **Should we enhance the macroprudential framework?**
  - Yes, according to EIOPA and the ESRB… in particular, Christine Lagarde, in her capacity of chair of the ESRB, calls for
    - ✓ Enhanced liquidity supervision, including the possibility to impose liquidity buffers
    - ✓ Countercyclical and systemic capital buffers to avoid excessive risk taking
    - ✓ Restrictions on dividend distributions for financial stability purposes
    - ✓ Concentration limits
    - ✓ Cross-sectoral inconsistencies (e.g. mortgage loans)
  - Scope of COM's call for advice much narrower that what EIOPA is going to propose

European Commission

Thank you