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Solvency II: Bringing the EIOPA proposal in line with European objectives

While the review process of the regulatory framework Solvency II has reached an important stage with the submission of **EIOPA's final Opinion to the European Commission**, some aspects remain open to improvement. The proposals for **Pillar 1 and related subjects** should take better account of the real and long-term nature of the insurance business. In particular, the EIOPA proposal would have the following effects:

- Increasing sensitivity to capital market fluctuations
- More volatility and pro-cyclicality
- Barriers to insurers' investment contribution to EU projects such as Capital Markets Union and Green Deal

By bringing the proposals in line with European objectives such as **Capital Market Union** and the **Green Deal**, insurers could facilitate **long-term investments**, and help the EU to achieve their **economic projects**.

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Solvency II Review: The Background

- **Mitigating the impact of short-term market volatility** on insurers' solvency position
- **Facilitating their ability to offer long-term life and pension products** with guarantees and to **contribute to the long-term financing** of the economy.[1]

These are some of the objectives of the ongoing **Solvency II Review**. However, some **proposals of the European Insurance and Occupational Pensions Authority (EIOPA) on the Pillar 1 aspects of the review will not meet these objectives**. Let us look at the reasons, understand why this is the case and what should be done instead.

Roadmap for the Solvency II Review

The Review process started in February 2019 with the publication of the **Request for Technical Advice on the Review of the Solvency II Directive (Directive 2009/138/EC)** by the European Commission (EC) to EIOPA, covering core aspects of Solvency II such as Long-term guarantees (LTG, for example the extrapolation of the risk-free interest rates) and methods, assumptions and standard parameters of the capital requirements (SCR).

According to EIOPA, three aspects[2] are especially important when considering improvements to Solvency II:

- Balanced updating of the regulatory framework
- Recognition of the economic situation and economic events like low interest rates
- Regulatory toolbox completion.

As a response to the Request, EIOPA carried out a **consultation**. To quantify the impacts of its adjustments and to gain deeper insights into the effects of the review, EIOPA conducted several assessments, also considering possible Covid-19 implications. Based on the outcomes EIOPA published its „**Opinion on the 2020 review of Solvency II**“[3] in December 2020.

The review process has now entered **a new phase**. The adoption of the legislative proposal by the European Commission is planned for the third quarter of 2021. It is now up to the **EC to decide** which elements of the Opinion should be reflected in their proposal and how these elements **interact with overarching European projects**.

1 Inception impact assessment – European Commission Roadmap
2 EIOPA website on the Opinion on the 2020 review of Solvency II
3 Opinion on the 2020 review of Solvency II, EIOPA

The 2020 Solvency II Review in Context

In parallel to the 2020 Solvency II Review, the EC is pursuing overarching political objectives, such as developing the Capital Markets Union (CMU)[4] and the Green Deal[5].

In September 2020, the EC adopted a new **CMU action plan**. The plan sets out several measures based on three main objectives:

- Support a **green and resilient economy**
- Make the EU an even **safer place for individuals to save and invest long-term**
- Integrate national capital markets into a **single market**

Among all the CMU measures, **action 4** is key in allowing insurers to help achieving the CMU goals as it shall **encourage more long-term and equity financing from institutional investors**. And, as the Commission Communication stresses, "Insurers are among the largest institutional investors".

> *"Action 4: The Commission will seek to remove regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection…"*, European Commission.

With more than 2.340 billion Euro in assets[6], the German insurance industry plays a key role as one of the most important institutional investors. It is the **long-term nature of their liabilities** that enables insurers to invest in corresponding long-term and partially "illiquid" assets. Insurers have the capacity to hold assets to maturity and are not forced to sell them in case of higher market volatility. Examples of those assets are equity and private debt, including investments in infrastructure and small and medium enterprises (SMEs). These characteristics are the reasons why insurers can be a "**natural partner**" to provide long-term funding to the European economy in line with the EC's political priorities.

Here is exactly where the **objectives of the CMU overlap with the objectives of the Solvency II review**: The Solvency II review is an excellent opportunity to reduce unnecessary regulatory barriers for long-term investments while ensuring that the European supervisory system remains robust. EIOPA's opinion plays a key role as it combines specific proposals with quantitative impact assessments.

4 Capital markets union 2020 action plan: A capital markets union for people and businesses, European Commission
5 A European Green Deal, European Commission
6 Source: EIOPA Insurance Statistics – Exposure data, at Q3 2020

However, considering the outcomes of EIOPA's impact assessments, some proposals would cause the opposite: They would **limit insurers'** full capacity to invest in the real economy because of (1) **additional overly conservative regulatory provisions** and (2) **missed opportunities to reduce existing barriers**.

EIOPA's opinion: Changes to Solvency II

Extrapolation is a very technical, but extremely sensitive topic of Solvency II. Insurers' liabilities are discounted using swaps data. However, the longer the maturity is, the less reliable those swaps data are. The reflection of less reliable data makes insurers' liabilities more volatile – in contrast to their robust and anti-cyclical business model. Therefore, from maturity 20 onwards, swaps data are no more used but a model comes in, the "extrapolation". Extrapolation can ensure that only reliable data are used to keep artificial volatility away from insurers' balance sheets. **Any change to the extrapolation method has an immediate effect.** According to EIOPA, the current extrapolation method should be replaced by **an "alternative" extrapolation method**. The so-called **convergence parameter** shall be set to 10 % and a **phase-in** shall ease the transition to the new method.

EIOPA proposes various **complex changes** to the **Volatility Adjustment** (VA). The VA is also an element of the interest rate term structure to discount insurers' liabilities. The VA serves several purposes. One of them is to take account of the fact that insurers can earn premiums higher than swap returns: It reflects insurers' ability to invest in illiquid assets and hold assets to maturity. Again, and just like extrapolation, changes to the VA have a direct effect on amount and volatility of insurers' liabilities and balance sheets. EIOPA proposes **introducing two company-specific application ratios and changing the risk-correction methodology while increasing the general application ratio**.

Interest rate risk shall be recalibrated to reflect the current negative rate environment, effectively leading to an **SCR increase**. Regarding the **risk margin**, no changes to the Cost-of-Capital Rate shall be made, but the calculation is amended with the so-called **lambda factor to consider the dependence of risks over time**.

Several new SFCR requirements are being proposed by EIOPA. These include new reporting and disclosure obligations for sensitivity analyses, among others analysing the effect of a convergence parameter value of 5 %, effectively leading to **a "shadow" regime with an implicit increase in capital requirements**.

EIOPA's opinion: Potential consequences

- Some EIOPA proposals would result in **higher volatility** of balance sheets and solvency ratios, leading to an effective decrease in "free" capital. Insurers would be **incentivized to reduce real assets**.
- Those proposals are **not a "balanced updating of the regulatory framework"** and **contrast the intention of the Solvency II review and CMU objectives**.

The **proposed alternative extrapolation method** with the calibration of the convergence parameter of 10 % would make insurers' capital resources **more volatile**. It incorporates market information on very long-term and less liquid rates which are both volatile and less reliable, and constrains the stabilising effect of convergence (*see chart 1*).

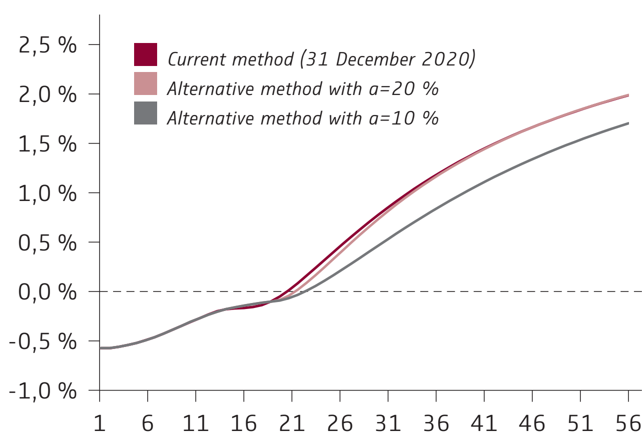
To react to the volatility and decline in SCR ratios, insurers would have to **restructure their investments** from real assets towards government bonds, which are already at all-time high price levels. A **pro-cyclical behaviour** would be enforced, most probably already before the final implementation of the proposals. To mitigate the impact, EIOPA proposes a phase-in mechanism, which **will not solve the method's drawbacks.**

We further expect consequences from the proposed changes to the **VA**. By **introducing a company-specific application ratio relating to liquidity properties**, the positive effect of raising the general application ratio is undermined. Because of the change in the risk correction methodology, the new method would provide less buffer during times of increased spreads, thus limiting its core anticyclical function.

EIOPA's opinion does not make the most of the **risk margin's potential**. The adjustment to consider the time

EIOPA's proposal constrains stabilising convergence

Chart 1 · Yield curves (interest rates as a function of time) for two different calibrations of the alternative method



Source: German Insurance Association

There is no need to change the extrapolation method:
- The current crisis caused by an unprecedented pandemic proves that insurers can cope with the market turbulences and very low rate environment without problems, as shown by stable Solvency ratios of German insurers.
- EIOPA's opinion already reflects the risk of a low-for-long scenario with the recalibration of the interest rate risk. The SCR is indeed the adequate place to reflect this risk, not the design of the interest rate curve itself.
- EIOPA has introduced their corridor method for the Ultimate Forward Rate UFR. The scheduled decrease of the UFR already reflects the interest rate perspective. An additional change to the extrapolation would be excessive.

dependence of risks would indeed lead to a lower risk margin, thus increasing capital resources, but is **not ambitious enough**. It would remain too high, as the collateral effect from the change in extrapolation adds up. Artificial volatility would still be added to insurers' balance sheets.

On the reporting side, long reports will not increase **transparency**. A "shadow supervisory regime" would set unclear risk management incentives and impose additional capital requirements **multiplying the effect on volatility and disinvestment from real assets**.

Our proposal: Balance between stability and investment capacity

The current extrapolation method has many advantages and **outclasses the new proposal**. However, should the new extrapolation method be selected, we propose setting the **convergence parameter to 20 %**. This would avoid significantly increasing the requirements and would **lead to less volatility than EIOPA's proposal**, as our analysis shows. In addition, this value and criteria to determine the extrapolation start (year 20) should be **fixed in the Directive itself (Level 1)**.

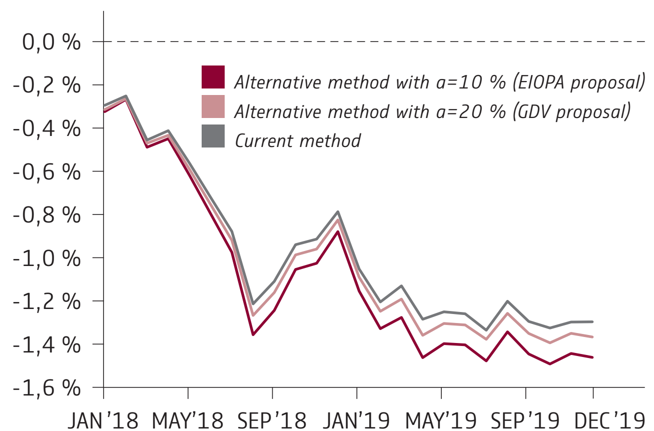
In the **VA calculation**, the general application ratio factor should be increased to 100 % or the liquidity factor be abolished, and the risk correction remain unchanged, so that the VA is both more realistic during stable times and has an improved buffer function during crisis times, thus easing long-term investments.

For the **risk margin**, we propose a lower lambda factor (95 %) and related floor (20 %), which will reduce the already mentioned procyclical effect. Other combinations which lead to a similar reduction are also possible. Diversification effects at group level should be reflected.

The SFCR reports should be further **shortened and more focused**. In any case, **"shadow supervisory regimes" should be avoided**. The economic consequences of Covid-19 show that the **current supervisory intervention ladder works well**.

GDV proposal reduces volatility

Chart 2 · Deviations of 30 year risk-free rate with starting point 31 December 2017



Source: German Insurance Association

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