JOINT POSITION PAPER

of the Italian, French and German Insurance Associations

on

SOLVENCY II

The European insurance regulation Solvency II is the most modern regulation worldwide. However, Solvency II has become too conservative – both in terms of appropriately reflecting the unique risk bearing features of long-term and illiquid insurance liabilities and also vis-à-vis the regulatory approaches of non-EU countries. Moreover, it is subject to reviews to integrate even more conservative aspects. In light of these reviews and an international regulatory level-playing field, it is of pivotal importance for the relative competitiveness of the sector and the ability to fully exploit its economic value creations potential of the policyholders and society/economy at large to:

- stop Solvency II from becoming even more overly conservative,
- improve the Volatility Adjustment,
- come to an adequate reflection of equity risk and other real assets.

Due to the complexity of Solvency II, it is key that the quantitative impact of material changes of the regulation is assessed carefully in a holistic approach. Only this procedure provides the legislators with an adequate base for their wide-reaching decisions.

1. Stop Solvency II from becoming even more conservative

Right with the start of Solvency II, a new strengthening was introduced at regulatory level with negative impact on insurers' long-term liabilities (ultimate forward rate). This year, EIOPA has advised the Commission on an own-initiative basis to implement changes that would have significant consequences for the capital requirements of French, German and Italian insurers (interest rate risk). The stressed curve of the EIOPA advice on interest rate risk is not in line with the general Solvency II extrapolation approach. All that goes against insurers' ability to offer long-term guarantees and financing in the interest of policyholders and the real sector requiring a stable private sector funding and a performant European capital market.

To take advantage of insurers' business model, regulatory stability is needed. In contrast to becoming more conservative, Solvency II should be improved on key aspects (risk margin). The cost-of-capital margin, on which the calculation of the risk margin relies, needs to be reduced to about half of its current level.

2. Improve the Volatility Adjustment

Insurers have the specific liability driven ability to invest in illiquid assets and hold assets on a long-term horizon. That ability helps to digest market volatility and serves as a safeguard in times of financial market stress. It is also a prerequisite to the supply with long-term insurance guarantees.

However, Solvency II does not fully reflect that unique feature of the insurance business model benefiting from relatively stable and illiquid liabilities – completely different e.g. from banks or UCIT-type funds. Solvency II has introduced a technical mechanism for insurers' liabilities to help insurers cope with market-induced volatility (volatility adjustment, VA). However, this instrument has so far addressed macro-prudential considerations, rather than attempting to capture the "natural" insurance sector risk absorption capacity. Because of restrictions, the effect of the VA is currently almost zero and it did not work properly during stressed markets in specific circumstances. Thus, the VA must be improved in all its components by removing unjustified constraints and by evaluating methodological refinements, including those implemented in the matching adjustment as for example the dynamic component. This would help the insurance sector and individual entities to better reflect the specific risk-mitigating features of its liabilities.

3. Come to an adequate reflection of equity risk

The regulation of insurers' investments in listed and unlisted equity is directly linked to the "European Commission Investment Plan for Europe". However, Solvency II penalizes long-term investments in equity and prevents insurers from financing growth and firms as much as they could. The capital charges for equity are the highest in Solvency II – regardless of their underlying risk. It is time to adapt the regulatory requirements for long-term equity investment strategies and strategic participations either indirectly as part of a comprehensive improvement of the volatility adjustment or of the risk margin either directly.

In December 2017, the Commission launched a call for tender for a study dealing with equity detention in six countries over the last 20 years. Based on the study, the Commission could decide to review equity treatment. The calendar urges to act fast to have a positive impact on growth before 2022.

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