Regulation and supervision compact
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Solvency II 2020 Review – Challenges and opportunities

Götz Treber
Member of the Extended Management Board
+49 30 2020-5470
g.treber@gdv.de

Peter Norwood
Senior Policy Advisor
+32 2 28247-35
p.norwood@gdv.de

The German insurance industry supports the Solvency II regime and believes it works well overall. The 2020 Review of Solvency II – a comprehensive review of the insurance supervisory regime – is an excellent opportunity to **bring the regime in line with Europe's top political objectives** such as the Capital Markets Union, the Green Deal, and the enhancement of Europe's international competitiveness, without however questioning the fundamentals of Solvency II and its risk-based character.

As part of the 2020 Review, EIOPA is currently drafting proposals for the European Commission that are due by the end of June, 2020. Consultations and quantitative assessments are part of the process for this. Now that EIOPA's submission deadline is coming closer and we have gained interesting insights from EIOPA's work so far, it is time to do a preliminary assessment. Our intermediate result is ambivalent:

→ On the one hand, we appreciate further steps to **strengthen small and medium-sized** companies and the application of **proportionality**.

→ On the other hand, we see a risk in some of EIOPA's current draft proposals **counteracting Europe's political objectives** and the **current regime** and **adding** new regulatory **barriers**.

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The need to reflect the long-term business model

A modern economy is unthinkable without efficient insurance policies that protect society and the economy from risks. Life insurance products offering **long-term guarantees** are inextricably linked to old-age provisions.

By offering long-term guarantees, insurers are an important source of capital: They have the capacity to invest in **corresponding long-term assets**. Since insurers' future payments can be reliably predicted over long periods of time, insurers are not threatened by sudden liquidity shortages that could force them to sell investments at an unfavourable time. Instead, unaffected by market fluctuations, they have the ability to hold investments until maturity and invest in less liquid assets.

Insurers are thus fundamentally different from many other players in the financial markets. As **long-term oriented investors**, insurers are an anchor of stability that can make a significant contribution to the long-term financing of the European economy – a **unique feature** that needs to be taken into account in the review process. Against this background, the insurance industry can make a **key contribution to Europe's political objectives such as the Capital Markets Union and the Green Deal**. For the Green Deal, for example, 279 Billion Euros shall be provided by private investors. The insurance industry can be an important partner – but only if the **2020 Review is of the same capital balance as today's regime**.

The start of Solvency II: Only four years ago

Solvency II has been applicable since 2016. It is a very complex piece of legislation, ranging from the Solvency II Directive 2009/138/EC, the Delegated Regulation (EU) 2015/35 (DVO), EIOPA requirements to national implementation and further interpretations. The changeover to this **holistic, risk-oriented and very complex** system was a huge step for insurance companies and supervisory authorities. New requirements had to be met in terms of capital resources, governance and reporting. Core elements of Solvency II are long-term guarantees measures, in short **LTG measures**. It is their objective to bring the market-oriented, short-term valuation in line with the long-term guarantees provided by insurers.

Early reviews of the supervisory regime

As Solvency II broke new regulatory ground, legislators decided to conduct early reviews of Solvency II. There are basically two reviews impacting the regime:

- The **2018 Review** that focused on the Delegated Regulation and changes to the Solvency Capital Requirements SCR.
- The **2020 Review** that is not limited to the Delegated Regulation, but covers the entire regulatory approach and – in terms of content – all three pillars of Solvency II and beyond (see Chart 1).

Preparation for the 2020 Review

Preparatory work for the review of the LTG measures began right after the start of Solvency II in 2016. Since then, EIOPA has been regularly publishing annual **reports on long-term guarantees measures and measures on equity risk**. The reporting will last until 1 January 2021. The reports cover the impact of the application of the LTG measures and are addressed to the European Parliament, the Council and the Commission. EIOPA's latest report was published in December 2019.[1]

Review 2020: The final countdown

According to **Article 77f** of the Solvency II Directive, specific Articles are to be reviewed by the end of 2020, for example:

- Extrapolation of the risk-free yield curve,
- Volatility adjustment and matching adjustment,
- Equity risk mitigation measures (symmetric adjustment and duration-based equity risk module),
- Extended SCR recovery period in case of crisis, and
- Transitional measures.

In addition, according to **Articles 111(3), 129(5) and 242(2)**, the **SCR standard formula** at the level of the Directive, the calculation of the Minimum Capital Requirements **MCR** and **group aspects** shall also be reviewed.

In February 2019, the **European Commission (EC)** issued a formal **Request for Advice**[2] to EIOPA on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

In June 2019, EIOPA published a first wave of consultation papers on its proposals for the **2020 Review on supervisory reporting and public disclosure** and insurance guarantee schemes[3].

1 https://www.eiopa.europa.eu/content/report-long-term-guarantees-measures-and-measures-equity-risk-2019
2 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190211-request-eiopa-technical-advice-review-solvency-2.pdf
3 https://www.eiopa.europa.eu/content/consultation-supervisory-reporting-and-public-disclosure

EIOPA‘s advice will affect all three pillars of Solvency II

Chart 1 · **Request to EIOPA for technical advice on the Review of the Solvency II Directive**

Quantitative		Supervisory measures	Reporting & Proportionality
Extrapolation of the Risk-Free Interest Rate term structure	SCR-standard formula: vt. risks, CAT, Simplifications	Macroprudential issues	Reporting and disclosure
Matching adjustment and volatility adjustment	Risk-mitigation techniques and other techniques to reduce SCR	Recovery and Resolution	Proportionality and thresholds
Transitional measures	Group supervision		
Risk margin	Risk-management provisions on LTG measures		
Capital Markets Union aspects	MCR		
Dynamic modelling of the volatility adjustment	Best estimate	Insurance guarantee schemes (IGS)	
SCR-standard formula: Interest rate risk	Own funds at solo level	Freedom of Services (FOS) and Freedom of establishment	
SCR-standard formula: Counterparty default risk	Reducing reliance on external ratings		

Source: European Commission, GDV

On 15 October 2019 EIOPA issued a second wave of consultation entitled **“Consultation Paper on the Opinion on the 2020 review of Solvency II”** [4]. The Consultation paper covers a wide range of areas, including:

- Extrapolation of the Risk-Free Interest Rate
- Volatility adjustment
- Long-Term Guarantee (LTG)
- Reporting and proportionality
- Group supervision
- Macroprudential policy
- Recovery and resolution

According to the Commission’s request, EIOPA’s advice shall include a detailed holistic impact assessment of all relevant effects, qualitative and quantitative, of EIOPA’s proposals at the European level and on each Member State. From October until December 2019, EIOPA carried out an information request covering a wide range of topics, inter alia:

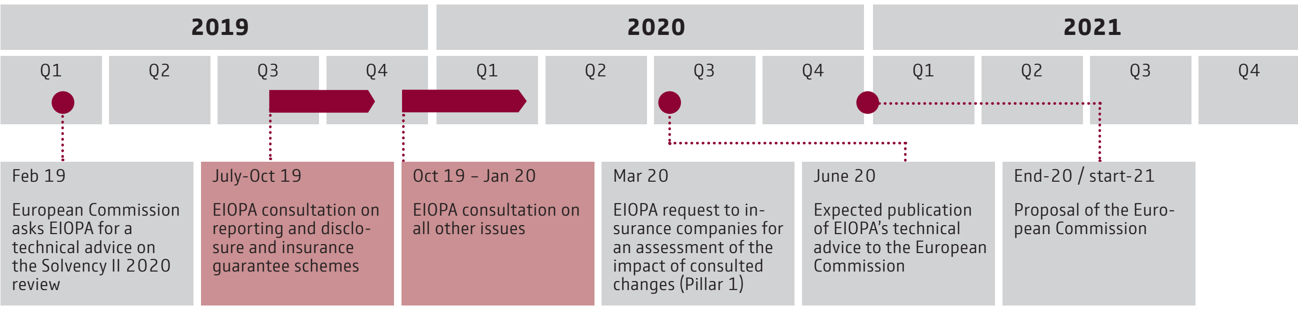
- Risk-free interest rate term structures,
- Technical provisions,
- Equity risk,
- Solvency Capital Requirement.

An information request on the combined impact of quantitative changes advised by EIOPA will be carried out in March 2020. Finally, EIOPA‘s investigations will result in an advice to the European Commission by 30 June 2020. The European Commission shall then submit its proposal to the Council and the European Parliament by the end of 2020 (see Chart 2).

4 https://www.eiopa.europa.eu/content/consultation-paper-opinion-2020-review-solvency-ii

The timeline is extremely tight

Chart 2 · **Solvency II Review 2020 timeline**



Source: European Commission, GDV

Positions of the GDV

The 2020 Review should be used as an opportunity to make sure that the Solvency II regulatory framework allows insurers to contribute to the fulfilment of the European political objectives (e.g. the Green Deal and Capital Markets Union) to their full potential, while, at the same time, ensuring that policyholders are sufficiently protected. This means:

- A **reliable extrapolation** is crucial for providing long-term guarantees. The extrapolation start of risk-free interest rates should be reduced or – second best – remain unchanged. Any increase would significantly limit insurers' capacity to contribute to initiatives such as the Green Deal.
- An ideal **Volatility Adjustment (VA)** would be a true boost to meeting the political objectives. It is a key tool to reflect insurers' long-term business model. The VA level should be increased significantly; the VA should be applied to all maturities and should be dynamic in the SCR.
- A shifted approach to **interest rate risk** is adequate. However, the risk factors should only be applied to the liquid part before the LLP. A floor to the risk curve should reflect asymmetric interest rate changes.
- Any new restrictions, limits and haircuts of own funds at **group level** would have a negative impact on capital resources.

The supervisory regime should be stabilized. Regarding supervisory measures, this means:

- The SCR should remain the **one and only intervention measure** and early-warning indicator. Any change would impact insurers' capital resources and would conflict with the current high security level. Public reporting of additional measures would be the worst of all results.
- The status quo of **Insurance Guarantee Schemes (IGS)** should be maintained. Minimum harmonization is not warranted because the level and scope of guarantee schemes need to be consistent with the legal environment in the Member States. The focus should rather be on supervisory convergence.
- If **Recovery and Resolution** requirements were to be expanded, they should focus on the supervisory layer following a breach of the SCR. Moreover, they should only be implemented in case of clear deficiencies of Solvency II.
- Considering the limited systemic risk inherent in the insurance sector and the **macroprudential framework** already in place, we see little need for new macroprudential tools or measures.

New supervisory requirements go along with additional costs and are sound as long as the costs do not outweigh the benefits. Proportionality is key to balance costs and benefits. A better application of proportionality would not only reduce unnecessary costs, but would also allow supervisors to focus on consumer protection and financial stability. Insurers' financial resources could then better be invested in such important projects as digitalization and improving the industry's global competitiveness. Our priorities in this context are:

- We need an overarching concept ensuring that companies have practical and efficient ways of **using proportionality**. Proportionality should be applicable to all insurers and go as far as the non-application of specific requirements, where appropriate.
- The **threshold to enter Solvency II** should be increased. We support a national maximum application of new thresholds.
- The **public reporting (SFCR)** should be streamlined and limited to information that is truly important for readers. The principle should be: No reporting requirements without clearly defined supervisory purpose.
- We also propose **amending Article 186** (cancellation period) in order to prevent misuse of the cancellation right.

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Issuer
Gesamtverband der Deutschen Versicherungswirtschaft e. V.
Wilhelmstraße 43/43 G, 10117 Berlin
Postfach 08 02 64, 10002 Berlin
Phone +49 30 2020-5000, Fax +49 30 2020-6000
www.gdv.de, berlin@gdv.de

Person responsible
Götz Treber
Head of Financial Regulation
Phone +49 30 2020-5470
E-Mail: g.treber@gdv.de

Publication assistant
Heike Strauß

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Author
Dr. Victor Cristobal

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