Supplementary feedback

of the German Insurance Association (GDV)
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on the European Commission's
Inception Impact Assessment (roadmap)
for the 2020 review of Solvency II
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The German insurance industry welcomes the possibility to give feedback to the European Commission's roadmap for the 2020 review of Solvency II and would like to make the following additional contributions.

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Summary / online feedback at the better regulation portal

The German insurance industry supports the modern, risk-based SII regime and believes it **works well overall**. Its level of security is very high. Particularly in the Covid-19 crisis, SII has proven its worth.

Nevertheless, the SII review should be used for **some important improvements**. Regulations that are overshooting from a risk perspective should be corrected in all three pillars. Specific amendments could bring SII even more in line with **European political objectives of high priority** like the CMU, the Green Deal, the enhancement of Europe's international competitiveness, and, of course, the economic recovery after Covid-19. To enable the insurance industry to contribute maximally to these priority projects, the high level of regulatory requirements should by no means be further increased.

Excessive **volatility** of their solvency position could hinder insurers both to offer products with long-term guarantees and to contribute to the stable, long-term funding of the EU real economy. Instead they could involuntary be forced to act procyclically and more short-term orientated, which would be contrary to the Commission's objectives as well as to the insurance business model with its long-term illiquid liabilities. In order to avoid such a detrimental result, artificial volatility must be reduced. This is the purpose of the **LTG measures** which must be sufficiently effective. This is also completely in line with the recommendations of the High Level Forum on the CMU. The Covid-19 crisis has re-established evidence that there is no room for dilution of these measures (e.g. changed extrapolation) but instead need for some improvements (e.g. VA). This holds in particular in an adverse economic environment with negative interest rates and heavy market fluctuations.

In general, it is important that regulation is based on the actual risks that insurers face. A realistic quantification of risks helps to make insurers more resilient to shocks and to increase policyholder protection. With respect to **interest rate risk**, this means to avoid both under- and overestimation when rates are already negative. Besides that, calibrations for EU matters must not be based on non-EU data.

Proportionality should be better applied in practice. Making proportionality work will have significant, positive and long-lasting impact on investments, employment and the security of policy holders.

Regarding the occurrence of several failures of insurers operating cross-border, there were suboptimal outcomes and revealed shortcomings in terms of cross-border coordination and cooperation between the supervisory authorities. The measures that SII provides for crisis situations and policyholder protection in a winding-up situation are sufficient and should not be mixed up with deficiencies in **cross-border supervision**. These deficiencies have recently been addressed by strengthening the information exchange and cooperation between the supervisory authorities and EIOPA[1].

We are convinced that the existing micro- and macroprudential regulation effectively addresses potential **systemic risk** which is limited in the insurance sector anyway. To further enhance **financial stability**, improved mitigation of artificial short-term volatility of solvency positions that might lead to procyclical behavior is the best option. The need for new macroprudential measures is very limited.

Sustainability risks should be integrated in qualitative risk management if they are material for the respective undertaking. Capital requirements should not have a "green discount" but always correspond to the undertaking's actual risks.

Apart from this, misuse of the **cancellation right** and market access of **third-country reinsurance** should also be addressed in the review.

Finally, we welcome that on basis of EIOPA's input the Commission services will carefully assess the **impact** of the proposed amendments. These significant decisions should be made on a large and meaningful **data basis**.

Detailed feedback: **attached paper**

[1] Article 2 para. 3 of Directive (EU) 2019/2177

A Context, problem definition and subsidiarity check

Context

The German insurance industry supports the Solvency II regulation and believes it works well overall. It has been a great success to implement this modern, risk-based supervisory regime. The level of security turned out to be very high. Particularly in the current Covid-19 crisis, Solvency II has proven its worth.

Nevertheless, the 2020 review should be used for some important improvements of Solvency II without, however, questioning its risk-based character. Regulations that are overshooting from a risk perspective should be corrected in all three pillars. Specific amendments could bring the supervisory regime even more in line with European political objectives of high priority like the Capital Markets Union, the Green Deal, the enhancement of Europe's international competitiveness, the promotion of digital finance and, of course, the economic recovery in the aftermaths of Covid-19. Generally, the already very high level of regulatory requirements should not be further increased in the review.

Problems the initiative aims to tackle

We share the view that insurers' financing of the real economy can be facilitated by sensible amendments of Solvency II. This includes a more appropriate – not "preferential" – treatment of specific asset classes given their low risk in the long run (an obvious case of long-term investments that still need a more appropriate capital requirement is property). However, the design of basic issues like the risk free interest rate term structure or the risk margin is of course even more important.

Excessive volatility of their solvency position could hinder insurers both to offer products with long-term guarantees and to contribute to the long-term funding of the European economy. Instead, contrary to their long-term oriented business model, they could involuntary be forced to act procyclically and more short-term orientated. To avoid this, the efficiency of the "long-term guarantee measures" is essential. The Covid-19 crisis has just re-established the evidence that there is no room for dilution of these measures (e.g. changed extrapolation) but instead need for some improvements (e.g. volatility adjustment).

The unprecedented low interest rate environment is indeed a major challenge for insurers. Regarding this subject it is particularly important neither to underestimate nor to overestimate actual interest rate risk when rates are already negative. Both types of flaws could lead to serious disadvantages. Besides that, calibrations for EU matters must not be based on non-EU data.

Specific risks are of course changing over time, which is reflected in the ongoing risk assessments and the underwriting and investment decisions of insurance undertakings. We agree that insurances enhance the Union's resilience to sustainability risks (e.g. nat cat) and that the insurance sector could support the green economic transition. However, it is exactly the principle of Solvency II as a risk based system that gives the right incentives. As soon as changes of the riskiness of investments and liabilities are measurable – not before –, these changes should be reflected in the regulation, too.

We agree that recent failures of insurers operating cross-border may affect citizens' trust in the single insurance market. However, these failures were first and foremost the result of inadequate supervision exercised by national competent authorities rather than triggered by incomplete recovery and resolution regimes or different IGS in Member States. Consequently, measures to tackle the problem should focus on ensuring a convergent level of supervision throughout the EU.

The current regulation and supervision struggles to implement proportionality properly and consistently within the Member states. While companies with a low risk-profile are unnecessarily burdened, consumers also foot the bill as they pay higher prices without need. Additionally, national supervisory authorities use resources to monitor low-risk companies that could be used more efficiently for more pressing issues. In consequence, making proportionality work in Solvency II yields high potentials for the industry, policy holders and regulators alike.

In addition to the points already mentioned by the Commission, a further problem should be tackled: misuse of the cancellation right. The provisions of Article 186 (cancellation period) are essentially unchanged since they were introduced with the second life assurance Directive[2] in 1990 and do not take account of the developments in legislation and jurisprudence since then. In particular, the lack of an absolute time limit leads to the emergence of an "eternal cancellation right", which allows for misuse at the expense of the remaining customers.

Ultimately, the opportunity offered by the review process should be seized in order to harmonize market access regulation for reinsurance business activities operated by third-country (re-) insurance undertakings. The

[2] Directive 90/619/EEC

absence of regulation leads to a fragmented landscape in Member States in terms of granting market access for cross-border reinsurance offered from licensed insurers or reinsurers outside the community.

Basis for EU intervention (legal basis and subsidiarity check)

We welcome the aim of assessing, updating and possibly simplifying existing EU prudential rules. Regarding the level of harmonization a sensible balance is needed that ensures both a level playing field and due consideration of national specifics (e.g. special products or existing schemes). This holds in particular for the issue of IGS.

B Objectives and policy options

Objectives

We consider policyholder protection and financial stability as main objectives of the Solvency II regulation. Strict orientation to the actual risks of insurers' business is decisive for this. In line with these overarching objectives, additional objectives – in particular from the Capital Markets Union and the Green Deal – should be supported where possible. Accordingly, the Commission has identified five purposes of the review:

1. *Mitigating the impact of short-term market volatility, facilitating the ability to offer long-term guarantees for consumers as well as long-term financing for the economy, but also accounting for the low-interest rate environment*

   We strongly agree that further improvements should be achieved in these crucial matters. For this, reducing artificial volatility of solvency positions is key. This holds in particular in an adverse economic environment with negative interest rates and heavy market fluctuations.

2. *Expanding the effective application of the proportionality principle, in order to alleviate undue regulatory burdens for smaller and less complex insurers*

   We also strongly agree that the application of proportionality needs to be improved. In particular, a clear focus on the underlying risks – and not on the scale of companies – when granting proportionate measures is mandatory to promote the interests of companies and policy holders alike. Hence, low risks need less regulation not only in theory, but also in practice.

3. *Deepening and strengthening the internal market for insurance services, by improving the level-playing field, and enhancing policyholder protection in situations of a possible failure*

As mentioned above, the integrity of the internal market for insurance services would essentially benefit from ensuring consistent supervision and enforcement of the current prudential framework. We believe that the recent revision of the ESA Regulations[3] will help to achieve this objective in the long run.

4. *Preventing the building-up of systemic risk and ensuring financial stability*

We are convinced that the existing micro- and macroprudential regulation already effectively prevents the building up of systemic risk which is limited in the insurance sector anyway. The best option to strengthen financial stability – in line with the first objective above – is to further mitigate the impact of short-term volatility on solvency positions: Otherwise the need for short run reactions of insurers or supervisors contrary to the long-term oriented insurance business model might lead to unnecessary procyclical behavior that could further fuel a crisis. The need for new macroprudential measures, on the other hand, is very limited.

5. *Ensuring that the framework provides appropriate incentives to address climate and environmental risks and opportunities in insurers' investment and underwriting activities*

We believe that it is reasonable and appropriate that insurers pay attention to sustainability considerations. However, politically motivated incentives that lead to a change of the fundamental principle of Solvency II as a risk based system have to be avoided. Incentives like a green supporting factor should not be introduced as long as there is no respective risk evidence. Also, the principle of investment freedom should not be restricted. Part of sustainable underwriting is an unbiased assessment of actual risks that leads protection by insurance. Beyond, to keep losses low and premiums affordable in the future sustainable risk reduction through prevention is key. Generally, we believe that in Solvency II regulatory provisions should focus on sustainability aspects that are financially material for insurers.

[3] Regulation (EU) 2019/2175

Policy options

For each objective there are two or more policy options that the Commission will consider:

1. *In relation to the long term financing of the economy and the provision of long-term insurance products with guarantees*

   We agree that in principle there might be both over- and understating of actual risks. However, we strongly support the Commission's first option to focus on fixing the known cases of overstating. Given the current very high overall level of prudence it could be accepted if there might remain some understating elsewhere. This policy option is particularly suitable to meet its objective; while the level of prudence would still be high enough to comply with the fundamental requirements (1-in-200-years event).

   The second option of trying to fix all kinds of over- and understating seems to be more problematic. If the Commission chooses this option, at least the target of avoiding a strong deterioration of overall solvency positions should not only hold on European level but also on the level of national markets. Otherwise this policy option would in fact be counterproductive for its objective of facilitating long-term guarantees and long-term financing in accordance with the Capital Market Union and the Green Deal.

   In our assessment we feel confirmed by the final recommendations of the Commission's High Level Forum on the Capital Market Union, which include the following points:

   - *"Better considering the long-term nature of the insurance business and assessing if the risk of forced selling of assets at adverse market prices is being estimated realistically when reviewing the treatment of equity and debt capital charges"*

   - *"Assessing whether the risk margin is too high and volatile for its policy purpose, reducing capacity for investment risk in capital markets"*

   - *"Ensuring that insurers' own funds are appropriately valued and are not too volatile, in particular looking at what improvements can be made to the Volatility Adjustment to avoid exaggerating either way the valuation of projected long-term liabilities and reduce artificial volatility"*

In particular, the High Level Forum further notes:

“The above recommendations urge a number of changes to remove barriers to greater investment by better reflecting the real long-term business model and real risks facing insurers. It is also important to avoid other changes to the prudential framework which could increase artificial volatility, exaggeration of liabilities or procyclicality. One area of concern that has been raised in this respect is the potential plans to change how the risk-free curve is extrapolated.”

2. *In relation to proportionality*

Proportionality is key to decrease the costs and promote the benefits of regulation. A better application of proportionality can increase profits of the industry and the security level of policy holders at the same time. In particular, reducing unnecessary regulation costs for low-risk companies, increases investments, improves the competitiveness and secures future solvency. Also, proportionality supports a risk-sensitive and more effective supervisory regime that additionally fosters the level of security for policy holders. In relation to policy options, we support the Commission’s first option to introduce provisions to make some proportionality rules automatic when some clear risk-based criteria are met.

3. *In relation to the enhancement of the internal market for insurance services and policyholder protection*

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. The measures and instruments that Solvency II provides for crisis situations are sufficient; in particular the SCR provides a sufficient early warning indicator and risk buffer to ensure early intervention by the responsible supervisory authorities. If recovery and resolution requirements were to be expanded, they should focus on the supervisory layer following a breach of the SCR and only to companies where they create a tangible benefit in terms of reduction of material systemic risk at EU level. Moreover, they should only be implemented in case of clear deficiencies of Solvency II. However, cooperation and coordination of supervisory authorities for cross-border activities need to be more effective.

4. *Regarding financial stability*

The Commission mentions the two options of introducing targeted measures that are listed in the Call for Advice or introducing completely new measures into Solvency II. What is missing, however, is a third option of improving existing Solvency II measures that are not listed in the Call for Advice. 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 (option 1 or 2). Much more important would be to increase the effectiveness of the existing long-term guarantee measures – in particular extrapolation and volatility adjustment – in order to reduce short-term volatility and procyclicality.

5. *With regard to climate and environmental risks*

Integrating sustainability risks in qualitative risk management requirements (including scenario analysis) is important. However, it should only take place if these risks are material for the respective undertaking. The second option of a general green supporting factor might undermine the fundamental risk orientation of Solvency II. Capital requirements should be lowered only if they are too high given the actual risk exposure of the undertaking.

C Preliminary assessment of expected impacts

Likely economic impacts

The economic impacts depend of course on the chosen policy options. We agree that, when choosing the options, insurers' likely important contribution to the financing of the economic recovery after the Covid-19 crisis should be taken into account.

We hope that in the end the initiative will be designed so that it indeed removes unjustified obstacles for providing long-term guarantees and making long-term-investments, in order to foster insurers' contribution to the long-term financing of the real EU economy, in particular of small and medium enterprises, in line with the objectives of the Capital Markets Union. We further agree that a better quantification of actual risks could help to make insurers more resilient to shocks. With respect to interest rate risk this means, however, to avoid both under- and overestimation.

Considering that own funds levels in average are much higher than required, the Commission expects that higher capital requirements for interest rate risk would not hinder insurers' contribution to long-term financing.

However – as rightly described as a problem – market-consistent valuations and the one-year time horizon underlying the calculation of capital requirements lead to high volatility of solvency positions. The possibility of short-term declines must be considered by insurers at all times. Even if the solvency position is quite high on average, any tightening of overall requirements may therefore impair the ability for long-term investments.

Thus, in order to avoid unintentionally causing a development towards involuntary short-termism, which would be contrary to the Commission's objectives, the initiative should neither increase the volatility of solvency positions (e.g. with a changed extrapolation) nor the overall level of requirements.

We agree that by strengthening the supervision of cross-border activities the initiative can increase competition in the EU and contribute to the orderly and efficient functioning of the single market for insurance and reinsurance services. Against that, further instruments and measures for recovery and resolution are associated with new bureaucratic burdens and costs for the insurers and result in less international competitiveness of European insurers. They should only be implemented if actual deficits in the existing measures and instruments for recovery and resolution could be identified.

Likely social impacts

We firmly believe that regulation must be based on the actual, material risks that insurers face. Improvements in this area contribute to further increasing policyholder protection.

Additional instruments and measures for recovery and resolution lead to new burdens on businesses and more expensive products. Further regulation should only be implemented if actual deficits in the existing measures and instruments could be identified.

The initiative rightly aims to tackle the problem of excessive volatility of insurers' solvency position which may hinder insurers' ability to offer products with long-term guarantees and may incentivize them to largely shift the risk to policyholders. For any proposed change, it should therefore be carefully considered whether it would help to mitigate this problem or whether it would even exacerbate it. This should in particular include gathering information on how the supply of long-term guarantees was reduced if the extrapolation of the risk-free interest rate term structure would be changed.

Likely environmental impacts

We agree that the contribution of the insurance sector to the greening of the economy and the European climate objectives can be enhanced if insurers are supported in taking a long-term perspective in their investments (e.g. by an unchanged extrapolation and an improved volatility adjustment).

Regarding underwriting, the assessment and pricing of a legal or actual risk that the insurer is asked to cover must be exclusively risk-based. Otherwise, the necessary balance between risk-based premium income and claims payments as a foundation for financial market stability would be severely jeopardized. Decisions in a sustainability process should be taken before or after the underwriting process.

Likely impacts on fundamental rights

We agree that the initiative is not expected to have a direct impact on fundamental rights.

Likely impacts on simplification and/or administrative burden

A simple and risk-based approach to proportionality yields high win-win potentials for consumers as well as companies. Indeed, decreasing administrative burden directly translates into higher profits and investments. Due to the large scale of the European insurance sector advanced and proportionate simplifications will have a significant, positive and long-lasting impact on investments, employment and the security of policy holders. This also increases the innovative capacity of insurers to address major challenges such as the digital transformation and climate change.

D Evidence base, data collection and better regulation instruments

Impact assessment

We welcome that on the basis of EIOPA's input the Commission services will themselves assess the impact of the proposed amendments.

Evidence base and data collection

We agree that these significant decisions should be made on a large and meaningful data basis. In case that it turns out that specific aspects cannot be adequately assessed with the available data, an additional request to undertakings should be considered. An example could be to gather information on how the supply of long-term guarantees was reduced if extrapolation would be changed.

Consultation of citizens and stakeholders

We appreciate the stakeholder information and consultation by the European Commission and EIOPA.

Implementation plan

We agree that there should be an implementation plan.

Berlin, 25.08.2020