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Need for a better balance

The Solvency II review and lessons from EIOPA's impact assessment

While the current **2020 Solvency II review** is ongoing, the German insurance industry has proven its stability throughout the COVID-19 pandemic. This underlines the effectiveness of the current Solvency II regulatory framework. However, **EIOPA's holistic impact assessment** shows that the draft proposals still have room for improvement in some areas, particularly with regard to three key aspects:

- → The **extrapolation method** used for the risk-free rate curve should not be changed.
- → The effectiveness of the **Volatility Adjustment should be increased**, and the **Dynamic Volatility Adjustment** should be included in the standard model.
- → The proposed calibration of the **interest rate risk** should be improved.

Addressing these topics in a consistent manner will enable and promote the achievement of other important EU political objectives such as the **Capital Markets Union**, the European Green Deal and the economic recovery after COVID-19.

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Solvency II review: ongoing situation

The goal of the 2020 Solvency II review[1] is to better reflect the long-term nature of the insurance business model, thereby strengthening the status of insurers as long-term capital providers. Achieving this will allow insurers to **contribute to key European objectives** such as the **Capital Markets Union**[2] (CMU) and the **European Green Deal** at their full potential.

The starting point of the review was the European Commission's „Call for Advice[3]" to the European Insurance and Occupational Pensions Authority (EIOPA) on 11 February 2019 (Directive 2009/138/EC).

On 15 October 2019, the EIOPA published a consultation paper[4] on the review of the Solvency II Directive. This paper made draft recommendations for a possible adaptation of the Solvency II Directive and the Delegated Regulation. EIOPA will deliver its advice to the European Commission at end December 2020.

As part of this process, early this year, EIOPA carried out a Holistic Impact Assessment[5] (HIA) to gain deeper insights into the effects of the review by analysing the **combined impact** of changes to technical provisions, own funds and solvency capital requirements. The reference date for the exercise was the 31 December 2019.

1 2020 Solvency II review
2 EU Capital Markets Union
3 Request to EIOPA for technical advice on the review of the Solvency II Directive
4 Consultation on technical advice for the 2020 review of Solvency II

COVID-19 changed not only the timetable

Due to COVID-19 the timeline of the review has been delayed by 6 months (*see Chart 1*). EIOPA has postponed the submission of its recommendations to the European Commission until the end of December 2020. The original deadline of 30 June 2020 could not be met, as EIOPA also wanted to assess the impact of the pandemic on the financial markets and the insurance business.

Thus, the next stage of the review includes an **update of EIOPA's Holistic Impact Assessment**[6] to determine the consequences of COVID-19. In order to carry out this impact assessment, EIOPA has sent a complementary request for information to the industry with the reference date of 30 June 2020.

5 Information on the holistic impact assessment of the review
6 Complementary information request on the holistic impact assessment of the Solvency II review

This publication gives an overview over the HIA's findings so far. The results reveal that many of the proposals currently under discussion would have **a direct impact on insurers' capital requirements**.

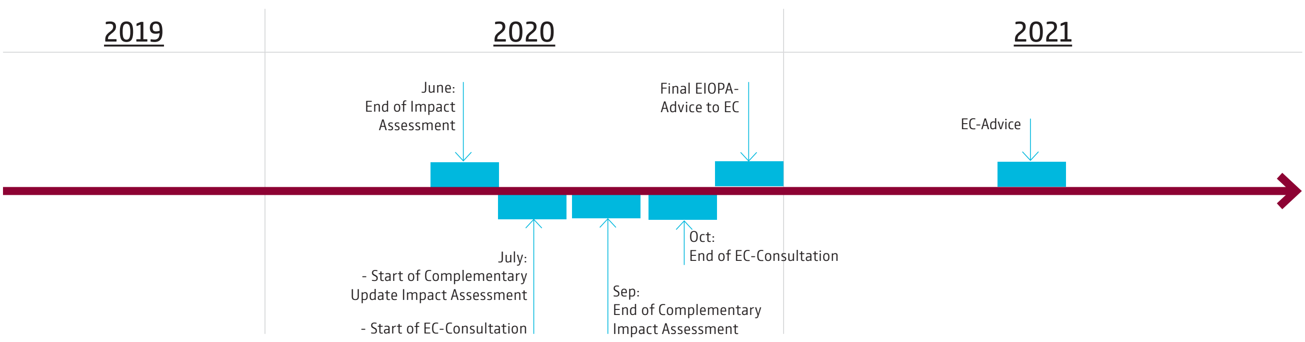
Need for a better balance – results of the Holistic Impact Assessment

The 2020 Solvency II review is an opportunity to improve the current regulation and ensure that it reflects the business model of insurers more accurately. Due to their liability structure, insurers are able to hold investments until maturity. As long-term investors, insurers can thus provide **financing to the European economy and exert a stabilising and anti-cyclical effect on financial markets**. This, in turn, enables insurers to make a significant contribution to the Capital Markets Union, Sustainable Finance and the economic recovery.

However, the HIA reveals that this **opportunity might not be taken**; instead, EIOPA is discussing tighter rules with far-reaching consequences going against the objectives of the current review process. The impact assessment shows that the insurance market would be strongly affected by these changes.

Despite the delay the timeline remains tight

Chart 1 **· New Timeline**



Source: German Insurance Association

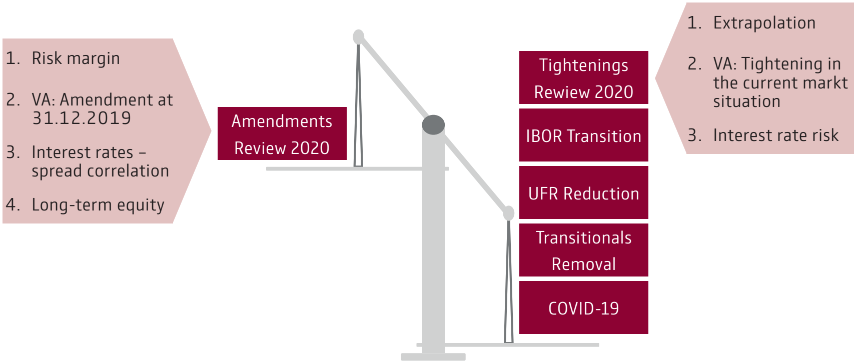
What have we learnt from the HIA?

The HIA reveals both lights and shadows in the current EIOPA draft proposals. The results show that while some of the discussed changes would be improvements (risk margin, for instance), there are a number of other changes that would have **negative consequences**.

- Especially worrying for the insurance market are the results regarding the **extrapolation of the interest rate curve**. German insurers would be strongly affected by a deferral of the starting point of the extrapolation or a change of the extrapolation method. The curve used to discount the provisions of insurers is based on available swap data. Since reliable swap data is not available for long-term maturities, an extrapolation of interest rates is necessary. This leads to stable and reliable long-term interest rates. In the HIA, EIOPA applied a new extrapolation method that takes non-reliable swap data into account and would lead to a significantly lower risk free rate curve. This would make companies' capital resources **much more susceptible to fluctuation**, which would result in undue pressure on insurers to act in a procyclical way, thereby creating **barriers to long-term investments** by insurers.
- **Another area of concern is the treatment of the interest rate risk**: Negative interest rates are currently not further stressed. The changes in the HIA seem to be justified taking into account current market conditions. However, we believe that technical changes need to be adopted to mitigate the negative effects.
- **Volatility Adjustment (VA)**: EIOPA applied several changes to the VA with contradictory effects. All in all, this will result in higher values of the VA when spreads on financial markets are low and lower values of the VA when spreads are high. Since the VA is designed to mitigate the effects of short-term spread widenings we consider this a negative outcome.

Balance in danger

Chart 2 **· Solvency II Review 2020**



Source: German Insurance Association

The chart above provides an overview of the impact of the EIOPA draft proposals on the Solvency II Regulation.

Challenges today

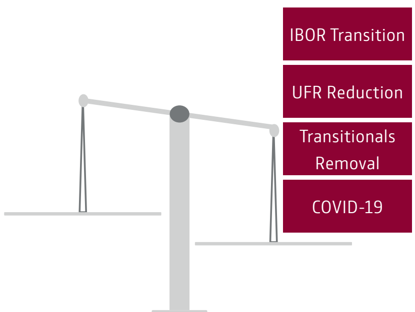
Even without these amendments, German insurers currently face a number of challenges stemming from regulation that have an impact on their solvency position (*see Chart 3*), for example:

- **The IBOR transition**: The instruments from which the Solvency II interest rate curve is derived will change in the next years. This is necessary because they currently rely on IBOR reference rates whose significance as reference rates is decreasing. However, these new instruments will lead to a lower interest rate curve. Thus, this purely technical transition which is not connected to any change in the economic situation will presumably increase liabilities, especially for long-term business.
- **Ultimate Forward Rate (UFR)**: Insurers discount their liabilities. Since there is no long-term market data available, the UFR is used to this effect. According to EIOPA's corridor method the UFR will continue to decrease in the coming years. As a consequence of that, the long-term liabilities will be particularly affected.
- **The removal of the transitional measures** from Solvency I to Solvency II. The current transitional measures will be phased out linearly until 2031.

In addition, the effects of the **COVID-19 crisis** on insurance companies remain a challenge for the insurance industry. German insurers are meeting their obligations despite the challenges resulting from the COVID-19 pandemic.

Many aspects impact presently the solvency position of insurers

Chart 3 **· Current Solvency II situation**



Source: German Insurance Association

What should be done – and what shouldn't

German insurers have strongly advocated for a moderate further development of Solvency II, particularly with regards to long-term guarantees.

Against this background, the current EIOPA draft proposals are a promising development. However, the overall package still represents a tightening of requirements, especially when interest rates are low.

Extrapolation of the risk-free rate curve:

Starting the euro extrapolation **no later than 20 years** when using the current method is appropriate. However, there is no need to change the existing extrapolation method.

An extrapolation start at 15 years should be considered.

Volatility Adjustment (VA):

The industry strongly supports focused improvements of the VA:

- increasing the general level of the VA to properly reflect the ability of insurers to earn returns above risk-free rates,
- applying it to all maturities, and
- avoiding artificial balance sheet volatility.

Dynamic Volatility Adjustment (DVA):

Applying a DVA in the standard formula, too, would be appropriate.

Interest rate risk:

We think that the risk factors EIOPA tested in the HIA are reasonable for the liquid part of the curve. However, the illiquid part of the curve needs to be derived from the stressed liquid part exactly with the usual extrapolation method. Only this procedure represents the changes in the interest rate curve which could occur in real terms.

Risk margin:

The level of the **cost-of-capital rate of 6% which is a key parameter in the calculation of the risk margin is inappropriately** high and should be lowered significantly.

We welcome that EIOPA proposed a slight change in the design of the risk margin by introducing a new parameter. As a result, the risk margin for long-term liabilities will be less volatile. However, we think that the choice of this new parameter could be changed to improve this effect.

What is at stake?

The review process is linked to other key initiatives at the EU level. An adequate review of the regulatory framework is essential to achieve the objectives of political priorities such as the **Capital Markets Union** or the **European Green Deal** whose importance has increased in light of the economic impact of the corona crisis. In our view, the review presents a unique opportunity to review the Solvency II regulatory framework in a way which facilitates the achievement of these overarching objectives at the European level while at the same time ensuring policyholder protection. This view is **shared by the Report on the Capital Markets Union** (CMU) by the High-Level-Forum: The review should "better consider the long-term nature of the insurance business" and "avoid exaggerating valuation of projected long-term liabilities and reduce artificial volatility."[7]

However, even at this early stage of the review, it must be noted that many of EIOPA's draft proposals would counteract the EU's objectives.

7 A new vision for Europe's capital markets – Final report of the High Level Forum on the Capital Markets Union, June 2020, p.41

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