2020 Review of Solvency II

Commission Consultation and GDV Positions

Executive Summary

- The Review of Solvency II takes place in the middle of an unprecedented global pandemic. This provides the opportunity to **integrate learnings from the pandemic** in the review but also to help advance current European priorities such as the **Green Deal and the economic recovery** after COVID 19.
- So far, we have seen that the **framework has proven its worth**. The key to its success is its rigorous and **risk-based approach** which needs to be maintained.
- However, we see the opportunity to increase the industry's resilience against **undue volatility** and thus to **stabilize the financial system**. This approach should be put in the center of the review instead of introducing additional layers of security such as unnecessary changes to the extrapolation of the interest rate term structure and to insurance guarantee schemes.

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1 Introduction

Solvency II, the European insurance regulation framework, is a modern, risk-based supervisory regime that was introduced in 2016 and is currently under review. The experience of the past years, including the ongoing Covid-19 crisis with its severe economic disruptions, has confirmed that **Solvency II works very well**. With its high level of security it fulfils its purpose to protect policyholders.

Thus, overall, Solvency II has proven its worth and should be preserved. Yet, there is room for specific improvements, and the system should be cautiously developed further. In doing so, the previous balance of requirements should be maintained. Tightening the already very conservative rules any further would be harmful not only for the insurance industry but also for policyholders and the investment capacity of insurers hampering their **role as long-term capital providers**.

If it is done right, this review can also provide a **significant economic stimulus**. With their very long-term business model built on reliability, insurers are an anchor of stability in the financial world, which is otherwise often driven by short-termism. For their policyholders, insurers accumulate capital on a large scale and invest trillions of euros across Europe. The Solvency II review offers the **chance to harness this huge potential even more by supporting the Capital Markets Union (CMU), the Green New Deal, the enhancement of Europe's international competitiveness, the promotion of digital finance and the economic recovery after Covid-19**. If unjustified obstacles to investment are removed and the strict risk orientation is maintained, the Solvency II review provides a unique opportunity that should be seized. In order to keep their policyholders safe when the going gets tough and to contribute to a future-proof and inclusive Europe, the German insurance industry recommends that the Solvency II review be guided by four basic principles:

- → generating robust results / avoiding unnecessary volatility
- → strictly consider the actual risks that insurers face
- → refrain from unnecessary specifications
- → always consider the cost-benefit ratio

During the review, a large number of rules across all three pillars of Solvency II will be under scrutiny. In addition, the inclusion of completely new areas of regulation is also under discussion. Based on the principles mentioned above, the German insurance industry takes the following key positions on the areas of quantitative regulations, supervisory measures, insurance guarantee schemes, proportional requirements and some further issues.

2 Quantitative regulations

Volatility and risk measurement

- Artificial volatility of solvency positions should be avoided
- Capital requirements should be strictly aligned to the corresponding risks

The solvency position of insurers should be sufficiently robust and present a meaningful picture of future prospects. For this, they **must not be distorted by heavy short-term fluctuations**. Artificial volatility of solvency positions could force insurers to act more procyclically and short-term oriented, contrary to the insurance business model with its long-term illiquid liabilities. Generally, **excessive artificial volatility could hinder insurers both from offering products with long-term guarantees** for the sake of consumers and from contributing to the long-term funding of the European economy. These multiple adverse effects need to be avoided, in particular by maintaining the stabilizing effect of the current extrapolation.

Capital requirements should reflect the underlying risks realistically. A better quantification of actual risks could help make insurers more resilient to shocks. Therefore, risks must be neither underestimated nor overestimated, because both cases could lead to wrong incentives and, in the consequence, to misallocations that endanger the security and the benefit of policyholders. Overestimation of risks could even hinder insurers from offering certain products and from investing in certain asset classes at all. Regulation that is overshooting from a risk perspective should, thus, be corrected or not be introduced in the first place. Key aspects in this respect are extrapolation, volatility adjustment, interest rate risk and further issues which we discuss in more detail in the following sections.

Extrapolation

- The bond criterion should be maintained
- The starting point for the extrapolation (LLP=20 years) should not be increased
- The established extrapolation algorithm should be maintained

For life insurers which often have very long-term obligations, Solvency II's risk-free interest rate term structure is the **main driver of their solvency position**. Hence, in order to get robust solvency results, it is crucial that this yield curve be based on reliable data stemming from sufficiently deep and liquid markets. At the long end, where this is no longer the case, the curve must be extrapolated. For the euro, the last liquid point (LLP), where extrapolation starts, is at the maturity of 20 years. Unnecessarily changing this key element of Solvency II would severely impair the reliability of the regulatory framework which is critical for a supervisory system for the long-term oriented insurance business.

However, there are discussions about a later start (LLP=30 years) or an alternative method of extrapolation. These changes could also require a departure from the current criteria for the LLP.

Currently, bond and swap markets both have to be deep and liquid. For non-extrapolated maturities, insurers must be able to match their obligations with bonds. The main reference to the bond market best reflects reality and should definitely be maintained.

Solely **looking at swap markets would be inappropriate**. The current net volume of the swap market is far too low to cover the long-term European insurance obligations. Banks would have to enter into huge amounts of new swaps, increasing the interdependency between the insurance and banking sectors. When these risks are further passed on, hedge funds will probably be the only counterparties available. As a result, systemic risk could increase. Furthermore, in order to match the floating leg of the swaps, insurers would have to invest massively in short-term instruments. This could effectively **crowd out insurers' long-term investments in the European real economy**.

Looking at the bond market, liquidity has not increased since the specification of the LLP for the euro in the Omnibus II Directive (bid-ask spreads, trading volumes, and trading book inventories point to a stable or even decreased liquidity). EIOPA's analysis of the matching criterion showed an LLP of 15 years although it implicitly assumed that insurers are the only buyers of bonds. The ratio of bonds available on the market (excluding the volume permanently withdrawn by the ECB) to technical provisions in Europe has significantly fallen. The residual volume criterion also confirms a lower LLP. Hence, the established criteria clearly rule out an increase of the LLP and suggest a reduction instead.

If extrapolation – contrary to the criteria – nevertheless starts later, non-meaningful data from markets that are not sufficiently deep and liquid can lead to distorted long-term valuations and artificial volatility of solvency positions. If **interest rates used for the calculation are doubtful or volatile, the present value of insurance payments that will be due decades in the future gets doubtful and very volatile**, too. This could lead to strong fluctuations of technical provisions, own funds and capital requirements. Even if these results didn't provide robust information, procyclical reactions of undertakings or supervisors might be triggered. Therefore, the LLP for the euro should not be increased.

During the **Covid-19 crisis, in March 2020, a later extrapolation start would have led to significant short-term volatility of insurers' solvency positions**. Fortunately, proper extrapolation with the current LLP has avoided such artificial volatility and further turbulences.

The proven **Smith-Wilson extrapolation method should also be maintained**. Changing the method is unnecessary and would require a completely new balance of requirements and parameters (in particular regarding liquidity criteria and convergence speed).

Volatility adjustment

- The effectiveness of the volatility adjustment (VA) should be increased
- The VA should be calculated without unjustified deductions and be applied to all terms
- A dynamic VA should be applicable in internal models and the standard formula

The VA has two main purposes. Firstly, the VA should mitigate the effects of short-term exaggerations of bond spreads. As bonds held to maturity are de facto only subject to some default risk, temporary spread fluctuations for other reasons must not be translated directly into artificial volatility of solvency positions. The Covid-19 crisis has just confirmed that **insurers have no notable liquidity risk and can weather asset market turmoil**. Secondly, the VA also has the purpose to reflect insurers' capacity to sustainably achieve returns that are greater than the risk-free interest rate. The long-term predictability of their future cash flow needs allows them to sustainably **earn an illiquidity premium with long-term investments**. This should be reflected in the valuation of liabilities.

The VA must be sufficiently effective to achieves these goals. Therefore, the effectiveness of the VA should be increased by **abolishing existing deductions** (e.g. the arbitrary 65% haircut) and **avoiding new deductions** (e.g. a percentage risk correction) that are unjustified in each case. Moreover, the VA should be fully applied to all maturities because illiquidity premiums facilitated by predictable cash flows can be earned permanently.

In addition, for the standard spread risk scenario, a VA value should be determined that is consistent with the scenario's actual spread values – this is the **dynamic VA**. For this, only the usual VA calculation must be applied to the new spread values. As a fallback solution, an implementation via reduced spread risk factors might be conceivable. In internal models, the dynamic VA should be maintained without conditions.

Interest rate risk

- The stressed curves should be extrapolated properly: first stressing, then extrapolating
- The downward risk curve should be supplemented by a floor

Interest rate risk is a particularly important part of the standard formula for the Solvency Capital Requirement (SCR). Thus, it is particularly important, too, that interest rate risk is neither underestimated nor overestimated. Currently, if interest rates are already negative, no further decline is assumed. In reality, however, the **risk of some further decline cannot be ruled out**. But if new shocks for negative interest rates are introduced, they should be realistic and not overestimate risk.

The main point is that interest rate risk refers to changes of the risk-free interest rate term structure which is based on market data up to the LLP and extrapolated afterwards. Solvency capital requirements for market risks must reflect the **risk of changing capital markets, not of changing regulation** (that provides for extrapolation). Therefore, the modelling of interest rate risk should follow the same two-step logic: Risk factors should only be applied to the part of the curve that is based on market data. The **resulting stressed curve should then be extrapolated with the usual algorithm**. This is the only way to obtain consistent, risk-sensitive and economically sound stressed yield curves and to calculate the true loss of basic own funds that would occur in the stress scenario. Moreover, this delivers appropriate results for all currencies which generally have different LLPs. Doing it the other way around, i.e. stressing the already extrapolated curve, **systematically leads to wrong results**. This should definitely be changed.

Furthermore, experiences with interest rate changes in times of positive rates don't fully apply to periods with substantially negatives rates. If interest rates were to fall too far and/or too long below zero, insurers would have to retreat from fixed income investments and switch to a combination of investing more in real assets and hoarding large amounts of cash. Therefore, assuming **excessive downward interest rate risk in the negative area does not make sense**. Moreover, a large proportion of recent interest rate declines was only caused by the interventions of the ECB, as Chief Economist Philip Lane publicly confirmed. However, the ECB's possibilities are not unlimited. In particular, the prohibition of monetary financing does not allow repeating once again the volume of asset purchases made so far. Therefore, at the current low interest rate level already achieved by the previous interventions, another decline of that magnitude is not to be expected. Consequently, it should not be assumed in the modelling of interest rate risk and a **floor should be added** instead.

Further issues

- The risk margin should be reduced to a realistic level
- Risk measurement should not be distorted by a green supporting factor
- The property risk factor should reflect property risk in the European Union
- Long-term equity risk factors should be applicable for the entire market

In the calculation of technical provisions, a **risk margin** is added to the best estimate of future payments. This additional buffer is rather high and contributes disproportionately to the volatility of technical provisions and own funds. The calculation is based on an excessive and outdated Cost-of-Capital rate of 6% which should be **significantly reduced**. As a fallback solution, a reduction of the risk margin by the discussed lambda factor might be conceivable if its effect is strong enough and not capped for longer maturities.

A general **green supporting (or brown penalizing) factor** might undermine the fundamental principle of Solvency II that capital requirements should reflect the actual risks of the undertaking. This risk-orientation is key to protect policyholders. Capital requirements should, thus, be lowered only if they are too high given the actual risk exposure of the undertaking. Instead, green investments can be **promoted by generally taking into account the specificities of long-term investments** and by removing general obstacles such as the excessive volatility of solvency positions.

An obvious case of long-term investments that need a more appropriate capital requirement is **property**. The current 25% risk factor for property risk in the standard formula is solely based on data from the UK commercial property market which is exceptionally volatile and not representative of a typical European insurer's real estate investments. An appropriate risk factor for the entire

European property market would have been 15% at most. A risk factor that reflects property risk in the post-Brexit Union **should not even exceed 12%**.

The specific risk factor for **long-term equity** is only applicable under prohibitive conditions. Most **problematic is the "quasi ring-fencing" requirement**, which can only be implemented in some EU legal systems with corresponding balance sheet structures, so that a level playing field is not given. This should be changed.

3 Supervisory measures

Recovery & Resolution

- There is no need to introduce additional layers of regulation on top of Solvency II.
- Further discussion should focus on supervisory measures that can support effective recovery, rather than on new powers of intervention.
- An extended recovery period and incentives for shareholders to provide additional capital would be helpful tools to address adverse situations.

Solvency II already provides authorities with a power to take any measures necessary to protect the interests of policyholders. The SCR ensures a high capital buffer that enables an insurance company to survive a 200-year event. Hence, there is **no need to create even earlier intervention triggers before the SCR is breached**. The focus should be on tools that support rapid recovery when the SCR is breached.

According to Article 138 para. 3 of the Solvency II Directive the supervisory authority shall require the insurer to take the necessary measures to ensure compliance with the SCR within six months from the observation of non-compliance with the Solvency Capital Requirement. The supervisory authority may, if appropriate, extend that period by three months to a total of nine months. We consider a **recovery period of at least two years** to be appropriate. The extension would provide sufficient flexibility for NSAs and affected undertakings to react.

The recovery measures should encourage shareholders to provide additional capital in case of crises, especially in case of a breach of the SCR. Any capital which has been provided to recover the SCR or to cover unforeseen losses as a kind of bridge financing in the crisis must **achieve market adequate returns**. Moreover, it should be **repayable after the end of the recovery period**, irrespective of other national product and profit-sharing regulations.

Macroprudential framework

- No additional macroprudential tools or measures should be introduced

Considering the limited systemic risk inherent in the insurance sector and the effective macro- and microprudential framework already in place, there is little need for new macroprudential tools or measures (e.g. an additional capital add-on tool or extensions of ORSA and PPP). They are neither necessary nor suitable to further strengthen the stability of the financial sector. Instead, the focus should be on improving the stabilizing elements in the quantitative requirements.

In particular, **no capital add-on ("own funds buffer") should be introduced**. The assumption that such an instrument would symmetrically complement the volatility adjustment (VA) is wrong. The VA (with its fluctuating amount) has not the purpose to create relief in bad times but to counteract specific distortions and to account for higher returns from illiquidity. This holds at any time and provides no justification for an additional burden in good times.

4 Insurance Guarantee Schemes

Insurance Guarantee Schemes

- National insurance guarantee schemes (IGS) should not be harmonized but be consistent with the legal environment in the Member States

A harmonized framework for national IGS would neglect the fact that some Member States have **already implemented well-established mechanisms** ensuring policyholder protection which are tailor-made to their markets. Germany, for instance, grants absolute preference for insurance claims in a winding-up situation, underpinned by a system of secured assets. For the life sector, an additional IGS is maintained to capture risks arising from long-term guarantees.

Requiring all Member States to establish guarantee schemes across sectors and in accordance with harmonized features would impair this balance and only lead to a costly bureaucracy without providing a benefit to policyholders. Moreover, the increased focus on IGS as a measure of last resort is oblivious to the fact that ensuring convergent supervision throughout the EU is key for effective policyholder protection. Guarantee schemes should and must **not compensate for the lack of supervisory convergence**. Recent legislation has attributed additional tools to EIOPA in this regard. Therefore, more emphasis and efforts should be directed at ensuring a harmonized level of supervision.

5 Proportionality and transparency

Proportionality

- The application of proportionality should be partly automated via the proportionality toolbox
- The quality of supervisory dialogue should be improved
- The application of proportionality should be monitored and evaluated

A wider and more consistent application will generate advantages for policyholders (*increased security*), supervisors (*stronger risk-sensitive approach*) as well as insurance companies (*reduced compliance costs & better future solvency*). The basic conditions to realize these mutual gains are a risk-based approach, simple and clear regulations, and mutual accountability. In general, all companies should be able to **apply proportionate measures based on their risk profile**.

A toolbox should be introduced to automate the application of proportionality and reduce transactions costs and legal uncertainty for NSAs and companies. Based on pre-defined risk-based criteria (such as solvency ratio, volatility of the SCR and systemic relevance), low-risk undertakings should be allowed to automatically apply a **non-exhaustive list of proportionate measures without an additional approval of the NSA**. This list should cover all three pillars of Solvency II and include simplified procedures, the frequency, timing and the extent of requirements. Of course, supervisors should be able to interdict the automatic application, but should be obliged to justify their decision and communicate that justification to the respective company.

While constructive supervisory dialogue is key to find individual solutions for proportionate measures, companies and supervisors occasionally report on difficulties. Hence, NSAs should establish **clear and transparent procedures**.

As a complementary action, regular evaluations will identify areas of improvement and initiate institutional learning. Thus, the committee on proportionality, recently created by the EIOPA, should publish a report about the application of proportionality on a yearly basis.

Thresholds for Solvency II application

- The thresholds for the application of Solvency II should be increased

Currently, very small insurance companies bear high costs due to Solvency II. As a matter of fact, national regulation can be more efficient than Solvency II, because it frees up financial resources that smaller companies can invest and use to secure the future solvency, which also benefits policyholders. Additionally, increasing these thresholds fosters competition, market and product heterogeneity.

Overall, we strongly **support EIOPA's proposal to increase the thresholds** as follows:

- €10m for the undertaking's annual gross written premium income [currently €5m] with the option for member states to increase the thresholds to €25m.
- €50m for the total of the undertaking's technical provisions [currently €25m].

Additionally, we propose a new threshold for a liability business: € 1.0m of gross written premiums or €0.5m of technical provisions.

Transparency toward the general public

- One report – one addressee: The SFCR should be divided into a short report for policyholders ("Two-Pager") and a separate, purely quantitative report for the professional public

The SFCR in its current form, addressing user groups with completely differing requirements at the same time, is not expedient. The costs for compiling this extensive narrative and quantitative report outweigh by far the documented benefit – as a GDV study has shown, only 0.03% of German households downloaded SFCRs in 2018.

Thus, we propose **to follow the EIOPA's draft proposal to split the SFCR** into a concise, easily understandable narrative report for policyholders (so called "Two-Pager") and a purely quantitative report for the professional public containing only relevant data. These data should only be based on the already published QRT. The **publication of additional quantitative data as well as a narrative explanation should not be required**, as the professional public possesses the necessary expert knowledge to draw relevant information directly from raw data.

6 Further issues

- Market access of third country reinsurers should be harmonized
- Misuse of the cancellation right should be ended
- Netting agreements should be exempted from the absolute priority of claims of the insured
- The definition of insurance business should be revised

Absent regulation on the market access for third country reinsurers in Europe is consistent with international standards but contributes to a fragmented regulatory environment in Member States and creates an **unlevel playing for the (retro-)cession of insurance risks outside the EU**. Therefore, the EU Commission is requested to seize the opportunity of the review to tackle the problem and ensure a harmonized approach.

Article 186 does not provide for an absolute time limit of the customers' cancellation right. As a consequence, by any error in the customer information an "eternal cancellation right" might be triggered. This is often **misused to retrospectively avoid the contractually agreed costs** and is also not in line with more recent legislation such as the Consumer Rights Directive, which provides for a time limit of 12 months under any circumstances. Solvency II should be amended in a similar way.

Article 275 (1a) stipulates that the claims of the insured take priority over all other claims. This makes it difficult for insurers to conclude netting agreements for derivatives. However, this recognized risk mitigation technique could help to reduce risk and to protect liquidity and should be supported. **Netting agreements** are therefore privileged in the European CRR and EMIR regulations and **should also be made possible under Solvency II** by a changed Art. 275.

We encourage the European Commission to follow up on the Expert Group's recommendation to investigate whether current regulation of business activities of financial institutions creates obstacles to financial innovation. Consequently, the **limitations on insurance business imposed by Art. 28 of the Directive should be aligned with the progressive developments** in the sector, such as digitalization.

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