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SOLVENCY II

Few flaws, big impact

COVID-19 and the economic challenges faced by the EU make it vital to correct the flaws in the EU's prudential framework for insurers

Major challenges lie ahead for the EU in achieving economic growth, technological innovation and global competitiveness and in addressing the risks created by climate change, ageing societies, cyber activity and pandemics. So, now more than ever, it is crucial that insurance regulation and supervision preserve insurers' capacity to play the significant role they do in addressing all these issues.

For over four years, European insurers have been supervised under the Solvency II framework, one of the most sophisticated risk-based regulatory frameworks in the world. Experience has shown that it works well overall, as the industry has demonstrated its resilience during the current COVID-19 crisis, and it has brought significant benefits in terms of risk and business management to both insurers and supervisors. Yet, experience has also shown that there are some key shortcomings that need to be addressed. In fact, although the shortcomings are few, their impact is great.

From the outset, European co-legislators acknowledged that adjustments could be necessary for long-term products and investments. They therefore embedded in the framework explicit requirements for its performance to be reviewed. Specifically, two reviews were foreseen: a limited one, which took place in 2018–19, and a more extensive one, which is happening now.

The 2018 review was narrow in scope and — disappointingly — the fixes it led to were even narrower. Indeed, some important issues

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from that initial review were left to the current one, which is why the industry characterised the 2018 review as a missed opportunity in some areas. The 2020 review is therefore the opportunity to instigate the improvements that are much needed to make Solvency II work as intended, for the benefit of consumers, society and the economy at large.

While the COVID-19 pandemic has led to some delays in the review process, it has also confirmed some of the industry's concerns over flaws in the design of Solvency II in the context of a crisis. With the pandemic, the regulatory framework is being put to the test. Understandably, the solvency ratios have experienced a decrease overall, but this is entirely normal as a result of such an event. Although the industry remains strong and well capitalised, with average solvency well above the solvency capital ratio (SCR), the flaws in the framework are exacerbated in these times of stress, as the industry warned several times would be the case.

The effects of the pandemic should therefore be used to inform the review, using the delays to investigate the problems and find the right solutions, so that Solvency II becomes fit for purpose in both normal and stressed market conditions.

Three priorities

The industry has three key priorities for the 2020 review:

- The treatment of long-term business needs to be improved to ensure the industry has the capacity and ability to continue to provide affordable, long-term products and to remove disincentives so that insurers can fully play their role as long-term investors.
- Simplification should be sought through the rationalisation of reporting requirements as well as a better application of the principle of proportionality.
- An efficient, effective and credible EU system of financial supervision needs to be ensured.

Addressing long-term business flaws

Improving the treatment of long-term business in Solvency II is crucial, given the leading role that insurers play in the provision

Solvency II & insurance guarantee schemes

At the request of the European Commission, EIOPA launched a consultation on the European harmonisation of insurance guarantee schemes (IGS) in July 2019. In its response, Insurance Europe opposed an EU initiative on IGS because national schemes vary significantly across Europe but generally work well within their local context and laws. Even a minimum level of harmonisation would create significant costs and pose complex challenges for which there may not be acceptable solutions.

The priority for policymakers should instead be to ensure that Solvency II is applied appropriately in all EU member states and that there is coordinated supervision of insurers working cross-border under the EU principles of the freedom to provide services (FOS) and the freedom of establishment (FOE).

National authorities should be allowed significant flexibility to choose the IGS features that best suit their markets and to reflect the significant differences between member states' social welfare systems, winding-up processes for insurers and insurance product lines. And it should be the home supervisory authority, rather than the host, that should be held accountable should there be a failure of an insurer operating under FOS/FOE.

Should the EC nevertheless provide evidence that minimum harmonisation of IGS at European level is required, Insurance Europe's preference would be for a "home" approach, combined with "host" elements.

Under such an approach, the home country would provide the funding, which would align with how companies are supervised, and the host country would provide the "front office" customer interface to facilitate customer, policy and claim identification, as well as communication in the local language. There would, however, be significant and potentially intractable operational challenges in applying this, or indeed any, harmonised approach across the EU.

Insurers are not alone in seeking improvements to Solvency II

In its June 2020 final report on the capital markets union project to bring about a single EU market for capital, the EC's High-Level Forum made five recommendations for the Solvency II review to encourage insurers to provide more financing for EU capital markets, all of which Insurance Europe supports:

- Better consider the long-term nature of insurance and assess 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.
- Change the criteria for the current long-term equity capital calibration to address the problem that almost no equity investment would currently qualify.
- Assess whether the risk margin is too high and volatile for its policy purpose, reducing capacity for investment risk in capital markets.
- Ensure that insurers' own funds are appropriately valued and 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.
- Propose Level 1 legislative changes and make the necessary Level 2 changes to improve the mitigation of procyclical effects that requirements may have on insurers' investment behaviour.

of long-term savings products and long-term investment in the European economy. There are a number of areas that create problems today for long-term business.

First, Solvency II currently creates artificial volatility in insurers' solvency positions and leads to an overestimation of the value of long-term liabilities. The volatility adjustment (VA) is a widely used measure that was introduced as part of the long-term guarantee package in the Omnibus II negotiations that finalised the Solvency II framework. Insurance Europe strongly supports the VA, but focused improvements are needed to ensure it properly reflects the ability of insurers to earn returns above risk-free rates and mitigate artificial balance-sheet volatility.

EIOPA's proposals, as part of its quantitative impact study, would certainly not achieve this objective. As they stand, they actually make the VA less effective, especially in times of crisis when it is most needed. The industry remains in dialogue with EIOPA and the European Commission to find solutions that would achieve the necessary outcomes without introducing undue complexity.

Second, the risk margin[1] is unreasonably high, especially for long-term business. According to EIOPA, the risk margin can reduce the industry's available capital by a staggering €189bn[2]. This unnecessarily increases liabilities and thus reduces available capital and risk-taking capacity. The current risk margin's excessive sensitivity to interest rates is yet another source of artificial volatility and makes it inherently procyclical. An excessive risk margin also has an impact on the cost and availability of certain products, particularly long-term ones, to the detriment of policyholders.

In spite of the industry's extensive technical evidence during the 2018 review that the risk margin should be lower and can be safely reduced, its revision was left to 2020. This is an area in which the EC recognises that changes should be considered, yet EIOPA so far seems to have very little ambition to address the flaws in the risk margin in a comprehensive way.

Last but not least, the capital requirements for long-term assets remain, in many cases, exaggerated and do not reflect the actual risks to which insurers are exposed. These long-term assets include the infrastructure and investments to fund the sustainable transformation that Europe needs to meet its 2050 goal of carbon neutrality. It is extremely important that

1 The risk margin is an amount over and above funds needed to pay claims and benefits. Its prudential purpose is to ensure that, should an insurer fail, there are additional funds above the best estimate of liabilities to make those liabilities transferable to another undertaking.
2 Based on EIOPA data for solo undertakings in the European Economic Area for Q3 2019

work in this area also takes a holistic approach, with either the reduction of specific capital requirements investigated or alternative mechanisms considered (such as the dynamic VA) that lead to the same outcome.

Increasing proportionality

Another fundamental area that needs addressing is the unduly onerous operational burden of Solvency II. Achieving improvements by making proportionality a real tool rather than a theoretical principle and streamlining the reporting requirements is vital to ensure that supervision is effectively risk-based and to avoid that, ultimately, policyholders have to bear unnecessary costs.

Currently, companies report little or no application of proportionality. This issue was also highlighted by the EU co-legislators as a priority in early 2020. While the framework requires that scale, nature and complexity must be taken into account in the exercise of supervision, it appears that national supervisors feel that they lack the legal background and tools to deviate from or waive a requirement. Consequently, EIOPA's proposal to add new simplifications — while welcome — is not enough to ensure that these will be effectively applied. Discussions with EIOPA in recent months confirm its greater openness to take an ambitious stance in the area of proportionality. The challenge is now to put in place some tools that will work effectively in practice.

Furthermore, with up to 95 Solvency II reporting templates for each company to complete and several qualitative reports both for the public and for supervisors, the burden of reporting is extremely onerous and overly costly. This is why the industry fully supported EIOPA's intention to create "a material reduction in the scope of quarterly reporting" and "an increased proportionality of supervisory reporting and public disclosure".

EIOPA's follow-up proposals did include some potentially helpful concepts, such as the introduction of a set of core and non-core templates and the split of the solvency and financial condition reports (SFCRs) into a policyholder and professional part. However, the way these have been introduced is not workable, as the reporting requirements are still onerous. For example, a written report would still be required for the professional SFCR section and the new standardised templates are excessive. In addition, the non-core templates are not automatically exempt from reporting. Moreover, the significant additional reporting and many proposed changes would in fact increase the overall burden — notably the new requirements relating to external audits and standard formula reporting for companies that use their own internal model.

Ensuring a stable & efficient supervisory system

To ensure an efficient, effective and credible system of financial supervision at EU level, any amendments to the current regime must be based on sufficient evidence of the need for change.

The ultimate responsibility of supervision is and should remain with national supervisors to ensure that the principles of subsidiarity and proportionality are not undermined. The role of national supervisors should not be compromised, as they are vital elements in the supervisory system thanks to their local expertise, direct contact with (re)insurers and, crucially, local accountability.

Insurance Europe remains of the view that EIOPA and national supervisors do not need any further significant changes to their powers to be able to fulfil their mandate. National supervisors need to apply Solvency II in a consistent and proportionate way and EIOPA needs to make greater use of its existing powers to enhance supervisory cooperation and convergence before any changes to EIOPA's governance or mandate are considered.

In addition, the very comprehensive, risk-based system is designed to require boards and supervisors to take a risk-based approach based on each company's risks and capital situation. It is vital that this remains so. In this respect, the industry regrets some actions taken during the pandemic to mimic reactions in the banking sector — notably bans on dividends (see box on p9) — which disregard companies' solvency situation and hence undermine the Solvency II framework in the eyes of the investor community.

Finally, it is important to note that the industry is not alone in calling for some of the key changes outlined above. The EC's High-Level Expert Group on Sustainable Finance made similar recommendations in 2018 and the High-Level Expert Forum on the Capital Markets Union set up by the Commission (see box on p25) has also highlighted the need for Solvency II improvements. It is now time to take heed of those recommendations to achieve an efficient review of the Solvency II framework.