Solvency II Review: Avoiding unnecessary complexity in targeted valuation items

Introduction

The revisions to the Solvency II Directive include a number of improvements to the treatment of long-term business. While many of these changes are welcomed by the insurance industry, they may also create increased and unnecessary operational burdens, if implemented in an overly prescriptive approach.

The industry supports a pragmatic approach to the implementation of the new requirements and, in particular, requests that care is taken to avoid these unnecessary burdens associated with the following elements:

- Volatility Adjustment (VA)
- Dynamic Volatility Adjustment (DVA)
- Availability assessment of expected profits in future premiums (EPIFP) at group level
- "Day 1" calculations subsequent to Solvency II-amending Directive applicability in 2027

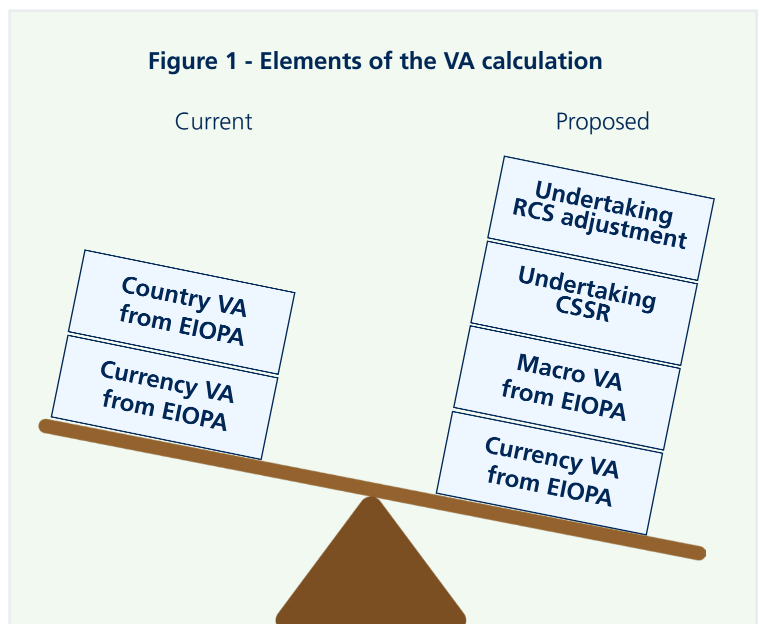
Volatility adjustment (VA)

While the industry welcomes most of the improvements to the VA design and calibration (from a Level 1 perspective[1]), there are concerns regarding the associated operational burden. In particular:

- Increased computational requirements, particularly with respect to undertaking-specific calculations
- Increased cost and time associated with gathering data and implementing new processes
- Increased risk management (Pillar 2) and disclosure and reporting (Pillar 3) requirements
- Supervisory approval requirements, without exception, across all Member States.

In addition, the industry notes that EIOPA's RFR Technical Documentation states that there is no specific VA at group level and that the influence of the VA at group level will be derived from the VA applied by each component of the group, according to the method of calculation of the group solvency. A pragmatic approach to calculating the impact of the VA at group level should be retained, even though the final VA calculation will be entity-specific.

Figure 1 - Elements of the VA calculation



1 In a separate Insurance Europe paper (July 2024), the industry highlighted that to deliver on the co-legislators' ambitions, it is imperative that the calibration of the risk correction does not add back volatility and pro-cyclicality. The initial ideas put forward by the European Commission for Level 2 calibrations are not supported by the industry. The paper proposes an alternative.

Industry proposals for the update to Level 2 Delegated Regulations

The calculation and derivation of the VA is detailed in the Delegated Regulation and supplemented in some parts by the European Insurance and Occupational Pensions Authority (EIOPA) risk-free rate (RFR) Technical Documentation. The associated details regarding the Credit Spread Sensitivity Ratio (CSSR) and other aspects below are expected to be specified in an update to the Level 2 Delegated Regulations. As part of the update, the industry requests the following inclusions:

1. The CSSR should not be required to be recalculated each quarter if no material changes have occurred.

Allowing undertakings to calculate the CSSR less frequently (for example, only annually) will simplify the process and reduce pressure during the busy reporting period without any loss of material accuracy to the calculations. EIOPA should seek to establish measures to minimise the frequency of calculation in appropriate situations (for example, if the CSSR is expected to be set to the cap of 100%).

2. Clarification that the CSSR should be calculated as the ratio between the sensitivity of assets to changes in credit spreads and the sensitivity of liabilities to changes of the VA.

Article 77d of the Directive states that the CSSR should be calculated as the credit spread duration of the assets divided by the "interest rate" sensitivity of the liabilities. The interest rate sensitivity should be clarified to be a sensitivity to only the VA (as per the EIOPA 2020 opinion, paragraph 2.26).

3. Exclusion of negative spreads from any VA calculations.

The EIOPA 2020 opinion proposed that negative spreads could be considered in VA calculation. This is not specified in the Level 1 Directive and should neither be included in future Level 2 or Level 3 measures.

Dynamic Volatility Adjustment

Undertakings who use an internal model (IM) are permitted to apply a dynamic volatility adjustment (DVA) which allows them to take into account the impact on both assets and liabilities from changes in spreads.

Article 122 (5) of the Solvency II Directive will require these undertakings to adhere to the newly introduced Enhanced Prudency Principle (EPP). The EPP sets a minimum capital requirements for spread risk for each undertaking based on the lowest of a) notional Solvency Capital Requirement (SCR) assuming the spread risk calculated using the reference portfolio and EIOPA methodology approach and b) notional SCR assuming the spread risk calculated using the insurer's own asset portfolio and EIOPA methodology approach.

To further specify the EPP, EIOPA is expected to update its 2017 "Opinion on the supervisory assessment of internal models including a DVA" (EIOPA-BoS-17/366) which already requires undertakings to consider the reference portfolio.

The new DVA measures will necessitate numerous adjustments to processes, with multiple VA versions – based on EIOPA's portfolio, the undertaking's own portfolio, or calculated under the new CSSR rules – needing review, approval and integration into the valuation cycles. This increases complexity and requires more coordination to ensure compliance.

Industry proposals for the update to EIOPA Opinion on DVA

To further specify the EPP, EIOPA is expected to update its 2017 "Opinion on the supervisory assessment of internal models including a DVA" (EIOPA-BoS-17/366). To alleviate the operational burdens, the industry requests the following clarifications to be included in the revisions to the EIOPA Opinion:

1. If the supervisor concludes that the internal DVA calculation meets the objective of the prudency principle, the prescriptive calculation requirements should be waived.

One of the core principles is that the use of the DVA should lead to "no undesirable risk management incentives". If that is established, the additional burden of the EPP is not necessary.

2. If the EPP is applied by the National Supervisory Authority (NSA), then the prescriptive calculations (ie reference portfolio calculations as well as company portfolio calculations) should be required at the very most on an annual basis.

3. DVA considerations should avoid multiple calculations for the notional VA and the CSSR.

The reason for building an IM, to have a proper reflection of the risks, could be outdone by the EPP requirement to use the most prudent of the calculations. The EPP assumes that current IMs do not have any prudency mechanism against overshooting, which is not in line with reality as most, if not all, DVA IM already have other mechanisms to counter any potential overshoot.

Availability assessment of EPIFP at group level

The industry does not support any additional requirement for the availability assessment of EPIFP.

The change proposed by EIOPA to explicitly include EPIFP in the regular availability assessment of own funds at group level according to Article 330(1) of the Delegated Regulation increases the reporting burden for undertakings. If an undertaking would then not provide this explicit assessment for EPIFP, these own funds would be considered not effectively available at group level.

Currently, EPIFP are treated in the same way as other own funds included in the reconciliation reserve, of which EPIFP are a typical component. The proposed change would add the need for justification for EPIFP, although there is no practical reason to treat EPIFP differently compared to similar own funds. In the case of EPIFP, this is especially crucial given that the theoretical nature of the EPIFP calculations makes it particularly difficult for undertakings to provide concrete proof for the availability at group level.

Furthermore, the current assumption of availability is based on the fact that established monetisation mechanisms enable undertakings to ensure the availability of expected profits. This means that undertakings can cover losses whenever needed within the required period of nine months, and the proceeds can flow freely within a group, which underlines the availability of these own funds at group level. Additionally, the monetisation of EPIFP is generally independent of whether they are derived from written or future premiums. Examples of possible monetisation mechanisms include the sale of legal entities, portfolio transfers, reinsurance arrangements and securitisation.

- Via reinsurance arrangements, undertakings would be able to monetise EPIFP under reasonable conditions for two reasons. Firstly, the regulatory restrictions in the calculation of EPIFP lead to a conservative estimation, which may be lower than the reinsurance commission received. Secondly, the competition in the reinsurance market makes it plausible that there would be supply for a reasonable reinsurance contract.
- For portfolio transfers, a lower bound for the transfer value of the respective insurance undertaking should be their assets over liabilities according to the Solvency II balance sheet. This value can be used to deduce the market value of an undertaking since Solvency II represents a market-oriented approach.

The proposed change would require undertakings to demonstrate the availability of their EPIFP to the respective supervisory authority. This would create substantial uncertainty for the affected groups, since the availability of EPIFP would depend on the outcome of the assessment and the confirmation by the supervisor. This uncertainty is particularly concerning when considering the impact that these assessments would have on group solvency.

Potential “Day 1” Reporting

With implementation of the new measures in January 2027, year-end 2026 reporting will be done on a solvency regime which is no longer being supervised.

This leads to the possibility that EIOPA/NSAs may request “Day 1” figures under the “new” regime. This could lead to a situation where companies have to complete year-end 2026 on the existing Solvency II and January 2027 reporting on the updated Solvency II.

Industry proposals for the “Day 1” reporting

While industry recognises that NSAs will likely wish to understand the impact of the regulatory changes on individual insurance companies, the industry would oppose formal and/or extensive additional reporting requirements.

In the industry’s view, there should be one official year-end 2026 position under the existing Solvency II regime (as was the co-legislators’ intent). Any assessment of the “Day 1” position should either remain an internal exercise or be independent communication with NSAs or market analysts.

The first formal reporting under the new regime should be Q1 2027.

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