Solvency II review: Appropriate Level 2 legislation is prerequisite for enhancing the competitiveness and investment capacity of the sector

To realise the potential benefits of the Solvency II review, Insurance Europe calls on EU member states to ensure that the Level 2 legislation fully reflects the co-legislators' political agreement and takes into account Europe's needs regarding investment, climate and digital transition, Capital Markets Union (CMU), and international competitiveness. Additionally, the European Commission should uphold its commitment to simplify and reduce reporting burden by 25%.

The first draft Level 2 proposals put forward to member states by the European Commission will not achieve the outcomes needed in all areas discussed – alternative calibrations are required and are justified by the technical analysis.

The Solvency II review in the context of the wider EU strategic agenda

Given the important role of the insurance industry in the economy and society, the Solvency II review needs to be regarded in the context of the wider EU strategic agenda on bolstering European competitiveness, delivering on the green and digital transitions and supporting progress towards completing the CMU.

European insurers have previously welcomed the political agreement on the changes to the Solvency II Directive reached in December 2023, particularly the changes introduced by EU co-legislators to improve the treatment of the long-term business because they create the potential for much needed improvements in the areas of capital and volatility.

To realise the potential benefits of the political agreement, it needs to be also fully reflected in the Level 2 legislation. Correctly designing and calibrating the technical details in Level 2 is fundamental to enhancing insurers' investment capacity, avoiding procyclicality and ensuring their competitiveness, while maintaining the high level of policyholder protection of the framework.

On proportionality, the changes to the Directive include some helpful improvements for very small insurers, but unfortunately the Review will result in higher operating burdens and costs for European insurers, including smaller ones. However, decisions at Level 2 will also impact the implementation and on-going costs.

Therefore, the technical details at Level 2, which are already under discussion are as important as some aspects of the Level 1 discussion and require political as well as technical discussion.

Getting the calibrations and details in the Level 2 legislation right

Calibrations related to the **treatment of long-term business,** such as the extrapolation of risk-free interest rates, the volatility adjustment, matching adjustment, the risk margin and the long-term equity submodule are important because they will significantly impact whether the Solvency II Review succeeds in safeguarding the insurance long-term business model. Changes to these aspects of the framework will directly influence the ability of insurers to offer guaranteed products, to invest long-term and to avoid being pushed into otherwise unnecessary procyclical behaviour.

The initial ideas put forward by the European Commission would weaken the agreed high level of political ambition, are not based on strong technical evidence, would not sufficiently reduce capital and volatility. During extreme market environments, the proposals would push insurers towards unnecessary procyclical behaviour. Unnecessary prudential buffers and unnecessary volatility will create barriers to investment, add costs to long-term products and reduce insurers' ability to take risk for the benefit of their policyholders and wider society.

In particular, the industry highlights the following:

- ***Volatility adjustment:*** To deliver on the co-legislators' ambitions, it is imperative that the calibration of the risk correction in the Delegated Regulation does not undermine the other helpful improvements agreed by co-legislators by adding back volatility and pro-cyclicality.

- ***Extrapolation of risk-free rates:*** The calibration for the technical parameters of the new extrapolation methodology which determine the starting point (the First Smoothing Point (FSP)) and the convergence to the UFR (i.e. the convergence parameter) should be chosen to minimise artificial balance sheet volatility, to avoid incentives for procyclical behaviour and to prevent pushing insurers towards extensive derivative usage.

- ***Risk margin***: There are widely acknowledged issues with the design and calibration of the current risk margin. In line with co-legislators' ambition to address these issues, the industry proposals will help significantly reducing the size and volatility of the risk margin consistent with the technical evidence and political ambition.

Beyond this, to prevent a further increase in reporting requirements and operational burden, in line with the EU policymakers' ambition to reduce burden on EU businesses, it is essential to draft the Level 2 and Level 3 instruments appropriately, in particular in the areas of **proportionality and reporting.**

Insurance Europe has prepared a series of technical papers which set out the industry's positions. These contain the industry's views on key elements of the future Level 2 and Level 3 instruments, technical analysis and evidence to support these views and important considerations regarding concerns about the initial proposals put forward by the Commission.

The insurance industry remains committed to constructive engagement and collaboration to ensure the successful implementation of the Solvency II Directive review.