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Survey: the impacts of Solvency II

Insurance Europe conducted a survey in the first half of 2018 of 87 insurers from 17 European markets, which together are responsible for around a third of the European industry's total investments.

As shown in Chart 1 overleaf, a number of elements have improved due to Solvency II. One should not underestimate the value of these improvements and, if anything, there should be a commitment to enhance their value in the review.

However, Solvency II has produced unintended consequences. Foremost among these is that insurers have shifted away from guarantees and long-term business. This effect has been reported by supervisors and insurers alike. Indeed, EIOPA's 2017 report on the long-term guarantee measures in Solvency II noted that supervisors have witnessed a shift due to the cost of Solvency II requirements and the introduction of the risk margin that is particularly high for certain products.

The results of Insurance Europe's industry survey support those findings, with 70% of companies with long-term business reporting that they have made changes to their business. While low interest rates were cited as one of the reasons for this, over two thirds of companies identified Solvency II as one of the causes.

In addition, Solvency II has had a negative impact on insurers' investment behaviour and today leads to sub-optimal asset allocations (see Chart 2). Nearly 50% of the companies surveyed reported that Solvency II was acting as a barrier to investing in assets related to the real economy. This figure rose to nearly 60% for companies using the standard formula.

SOLVENCY II

Big ambitions

After the missed opportunity of the 2018 review of the EU's regulatory framework for insurers, the 2020 review needs to be ambitious

The EU's Solvency II insurance regulation, which has been applied since January 2016, is the most comprehensive and sophisticated regulatory framework developed on such a large scale in the entire global insurance industry. It places risk management at the centre of the management of insurance companies and promotes advanced risk management practices.

Solvency II continues to be strongly supported by European insurers. However, as for any sophisticated framework, some of the assumptions, methodologies and calibrations decided on a few years ago need to be reviewed to ensure that insurers can continue to provide the full range of products that customers need and value, along with their vital, long-term funding of the European economy.

There are many positive aspects to Solvency II that create clear improvements to the regulation of EU insurers and give rise to benefits for their customers. Solvency II notably allows for advanced and tailored economic management of the business and the balance sheet through a risk-based approach that includes using refined tools such as internal models.

Nevertheless, experience has also confirmed the insurance industry's fears that the regulatory framework results in a number of negative consequences in key areas such as insurers' ability to offer attractive long-term products and to invest in diversified long-term assets. Indeed, the market-based nature of the framework and some of its uneconomic assumptions make insurance business appear artificially short-dated and more volatile than it really is.

When finalising Solvency II back in 2013, policymakers recognised the importance of the long-term guarantee measures for the insurance business as a whole, since they are aimed at addressing the issues of artificial volatility and pro-cyclicality risks. They also acknowledged that it was difficult to get the design and calibration of such an ambitious and comprehensive framework right first time. Therefore, requirements to review the framework were built into the directive to make sure it works as intended and to make changes where needed: these were the just finalised 2018 review and the recently launched 2020 review.

2018: a missed opportunity

The 2018 review is today viewed by the industry as a missed opportunity to support the growth priorities of Europe. While certain improvements have been made to the framework in terms of simplifications and some fixes of technical inconsistencies, these have been limited and will ultimately have a minimal impact in terms of removing unnecessary barriers to fostering Europe's growth priorities.

For example, the postponement of the risk margin[1] to the 2020 review is a prime example of a missed opportunity to enhance the industry's investment capacity. The industry provided extensive technical evidence that the risk margin could be safely reduced and that the EIOPA recommendation contained some assumptions that could be challenged. EIOPA has, however, decided not to re-evaluate its advice and the Commission did not challenge EIOPA's position. According to EIOPA, depending on market conditions, the risk margin can add a staggering €160bn[2] to the capital the industry needs to hold for its European operations. This negatively impacts all insurance business, but particularly affects longer term products.

On the other hand, the proposal on capital requirements for long-term equity investment is potentially a good step in the right direction, although it remains to be seen if and how it will work in practice.

2020: be bold

From the insurance industry's perspective, the 2020 review should be a comprehensive, but focused, exercise with targeted improvements to the framework that aim to address flaws and reduce unwarranted prudence where relevant. But, due to its sophistication, a careful balance needs to be found when attempting to introduce changes, especially when pursued in a

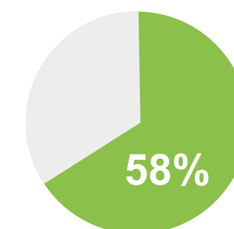
Chart 1: Companies that have seen improvements due to Solvency II

Element	% of companies
Risk management/governance	96%
Asset/liability management	76%
Regulatory harmonisation	63%
Data quality	89%
Internal models	47%
Other benefits	30%

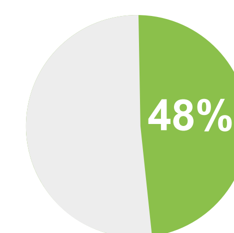
Chart 2: Companies investing less than optimal amounts in key assets due to Solvency II

Asset class	% of companies
Listed shares	27%
Unlisted shares	23%
Long-term corporate bonds	28%
Private placement/unrated debt	28%
Infrastructure	19%
Property	19%

Chart 3: Unintended impacts of Solvency II



"Solvency II contributed to a negative impact on guarantee business."



"We invested less than optimally in the real economy due to Solvency II capital requirements."

Overly prudent capital requirements

Volatile and overly prudent capital requirements placed on insurers can have a number of unintended and detrimental effects on insurance customers and the wider economy.

For the consumer, they can potentially lead to higher premiums and lower benefits, fewer attractive and useful products (eg long-term products with guarantees) and lower benefits as a result of sub-optimal investment strategies.

For the economy, insurers' reduced ability to invest in diversified long-term assets has an indirect impact on the creation of jobs and economic growth, while the availability of fewer suitable retirement savings products puts more of the strain of retirement funding back on governments and individual pension savers.

When higher capital is needed because of real risks and volatility, the consequences should be accepted. When excessive capital is due to incorrect measurements and overly cautious regulatory design or calibration, they should not. A great deal of effort has rightly gone into ensuring that companies have sufficient capital. Similar effort should go into ensuring that companies do not have too much capital relative to their actual risks so that they can continue to play their role in the economy.

piecemeal manner. The impact of changes needs to be carefully considered at all levels.

The industry welcomes the EC's recognition of its role in society. This includes protecting citizens, businesses and organisations, providing long-term savings and pensions, and significant investment to support the European economy and its long-term and sustainable growth. Insurers' counter-cyclical business model, both life and non-life, also means they contribute to financial stability during a crisis, rather than amplifying risk, and pursue stable, long-term investment strategies.

It is fundamental that any adjustment that might be proposed preserves the equilibrium of the framework and fits with the economic approach that underpins it, rather than taking an overly prudent stance that could prove harmful in the long run for the entire system.

The 2020 review is a key opportunity for co-legislators to:

- improve the design and calibration of the framework;
- address areas that do not work as intended or have given rise to unintended consequences for the products insurers offer and their investments; and,
- support and enhance insurers' role in Europe's society and economy and their competitiveness internationally.

"When higher capital is needed because of real risks and volatility, the consequences should be accepted. When excessive capital is due to incorrect measurements and overly cautious regulatory design or calibration, they should not."

It is vital that the review does not lead to an increase in overall capital requirements. The simplistic idea that more capital is always better should be recognised as false (see box opposite). Too much capital can be as damaging as too little. Let us not forget that the Solvency II framework is already calibrated to a level designed to ensure that every insurer is able to withstand 1-in-200-year events. This level of calibration provides a very strong and significant level of protection for consumers.

While it may be natural for supervisors to be conservative, they should also take responsibility for assessing the unintended consequences of their conservativeness and making these clear to the co-legislators. It is the co-legislators who are ultimately responsible for balancing all regulations against overarching policy priorities that include economic growth, long-term investment, building a sustainable future and improving EU citizens' access to protection and pension/savings products.

The insurance industry's key priorities for the 2020 Solvency II review can be summarised as:

- Improve the measurement of insurers' liabilities, better supporting the link between assets and liabilities to correctly reflect the real economic risks faced by insurers and targeting sources of undue volatility.
- Enhance proportionality and its application in practice.
- Improve reporting by focusing on preserving what is actually needed and has proven useful for supervisors and the public, while removing what has proven to be an excessive burden on companies with no benefit for any stakeholder.
- Preserve the effectiveness of internal models.
- Level the international regulatory playing field.

A well performing insurance sector has much to contribute to society. And an effective risk-based regulatory environment is essential for a healthy industry. Insurance regulation needs to be strong enough to protect policyholders, but should not hinder insurers' ability to provide customers with protection and long-term savings and to support economic activity through the products they provide and the investments they make. Risk-based regulation needs to be carefully designed to measure the actual risks.

As work on the 2020 review of Solvency II gets underway, the insurance industry remains committed to offering technical expertise, experience and evidence to support the discussions.

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 provide further protection to customers.
2 Based on EIOPA data for solo undertakings in the European Economic Area at the end of 2017