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Solvency II one year on: successfully implemented, but excessive conservativeness risks harming consumers, long-term investment and economy

While regulatory framework brings benefits, several issues must be addressed

The many layers of conservativeness built into the design of Solvency II and its tendency to treat insurers like traders instead of long-term investors could harm consumers, long-term investment and the economy. As such, policymakers need to take action to make the framework more reflective of reality, according to Insurance Europe, the European insurance and reinsurance federation.

For example, the scenario, known as the base case, that Solvency II requires insurers to use when calculating their liabilities — the assets they need to back policyholder claims — assumes that interest rates will stay low for the next 20 years[1]. However, this is generally considered to be an unlikely scenario.

Other examples of conservativeness in Solvency II include:

- Insurers are generally required to ignore the actual yields they expect to earn on the assets backing liabilities, and assume that they invest all of their assets into almost risk-free investments, earning virtually no return. Although earnings are currently low compared to the past, it is still possible to earn some return on portfolios of equities, property, bonds, covered bonds etc.
- Again, when calculating liabilities, insurers must include notional elements (the risk margin and the market value of options) that are not needed to actually pay claims. When Solvency II was designed, these were not expected to be large amounts, but in practice can be very large and be another source of artificial volatility.

Olav Jones, deputy director general of Insurance Europe, commented: "As demonstrated by the results of the recent European Insurance and Occupational Pensions Authority (EIOPA) stress tests, Europe's insurers have done a great job of implementing Solvency II, despite the significant challenges they faced. For example, EIOPA reported that 100% of companies tested met their minimum capital requirements (MCR) and 99.98%[2] met the much higher Solvency Capital Requirement (SCR). However, just because insurers have enough capital to cope with this conservative approach does not mean it is not wasteful or will not have consequences. Important improvements are needed to ensure that the framework works as intended, justifies the huge cost and effort involved in developing, implementing and operating it, and to avoid unnecessarily disincentivising insurers from making much needed long-term investments in the European economy."

Issues that require attention include:

- The need for capital requirements to reflect the true risks that insurers face. Currently, when insurers make long-term investments, Solvency II treats them as if they are short-term traders and bases the risk measurement on short-term risks. While there has been work to address this issue, unnecessary barriers to investment and costs remain, impacting all forms of long-term investment including equity, corporate bonds and property. Unless fully addressed, this could have a range of negative effects, including reduced long-term investment by insurers, lower returns and less protection for policyholders and insurers, which can be pushed towards more pro-cyclical behaviour.

- Simplifications and practical application of the proportionality provisions allowed by Solvency II. This will help Solvency II to become more workable in practice and avoid unnecessary costs for all insurers, and is particularly important for small and medium size insurance companies.
- More appropriate calibrations and methods to better reflect the true risks and liabilities in several specific areas including longevity risk, catastrophe risk and currency risk.

Jones said: "The industry has strongly supported Solvency II and its shift towards a strong risk-based approach. However, for this to work, it is vital that the risks are measured in the right way and it is not excessively conservative. The ongoing work regarding the Capital Markets Union, the current Solvency II SCR review and the wider Solvency II review to be completed by 2020, provide the perfect opportunities to make these important changes and ensure that Solvency II works, and avoids causing harm to consumers, the economy or our industry."

After 15 years of development, Solvency II introduced fundamental changes in how insurers are regulated and set very high requirements for solvency capital, internal risk management and reporting. These requirements ensure extremely high levels of protection for customers and harmonisation of rules across Europe. During Solvency II's development, problems were encountered in devising a way to properly measure the investment risks faced by insurers who provide guarantees to customers. This led to delays, but also to vital improvements to the framework in the form of changes, referred to as the long-term guarantee (LTG) measures, to better reflect the real economics and risks of long-term insurance.

Jones added: "The LTG measures are an essential component of Solvency II. Without them, it simply wouldn't work. However, further improvements are needed to ensure they are effective."

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Notes for editors

1. For euro.
2. Measured by assets.
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