Position Paper

Response to EC inception impact assessment on Solvency II Directive review

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Summary

Insurance Europe welcomes the EC Inception Impact Assessment and agree to a significant extent with its objectives and policy options. However, there are some key omissions and some refinements that are necessary to ensure the right outcomes.

Solvency II (SII) is strongly supported but is excessively conservative and has some measurement flaws and excessive operational burdens that create unnecessary costs and barriers, in particular relating to the provision of long-term products and investments. The SII review should not lead to an increase in capital requirements and, for certain products, a better reflection of the real risk will lead to a justified release of capital. This outcome is necessary for insurers to continue to **provide long-term products and fulfil their role in supporting recovery, sustainable growth and transformation to a net-zero carbon economy.**

On objectives and policy options:

- Objective 1 is supported. However, while **mitigating artificial volatility** is key, two other elements should be added: **ensuring insurers' liabilities are not exaggerated**, especially long-term liabilities, and **ensuring capital charges for investments are appropriate**. Given concerns that SII can overstate liabilities and some capital requirements and create artificial balance sheet volatility, it should also be made clearer that policy options that result in justified and needed reduction in overall capital requirements will be considered.

- Objective 2 is supported.

- In objective 3 there is **no need to enhance protection** since SII, when implemented appropriately, offers sufficiently high protection. The focus should be on **ensuring SII is applied appropriately and on supervisory coordination of FOS/FOE**. Instead of harmonising IGS, member states should have flexibility to choose features that best suit their market.

  Systemic risk is limited for the insurance sector and SII is already very comprehensive. Any new measures should be limited to applying the IAIS holistic framework, avoiding procyclicality, and should not go beyond the EC CfA.

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Insurance Europe does not support non risk-based reductions in capital requirements as incentives to address **climate change. Removing SII barriers** will create strong enough incentives when combined with insurers' own natural interest and business model together with the EC's powerful regulatory initiatives (SFDR, Taxonomy, NFRD) and the wider EU Green Deal.

Two objectives should be added:

- Ensuring the **international competitiveness of the European industry**. SII is extremely conservative — due to the measurement flaws and overall approach to calibration. Other jurisdictions appear to take much greater account in the design and calibration of their regulatory frameworks of the special characteristics of insurers' long-term business model as well as of their economic and social goals.

- **Simplifying & streamlining reporting requirements,** in line with the EC's fitness check of supervisory reporting requirements.

On economic and social impact:

The EC indicates that strong industry capitalisation means that increasing capital requirements (eg for interest rates) would not have an adverse impact. This is wrong because even if it appears an insurer can "afford" a capital increase, the absolute level of capital remains important and artificial volatility creates a need for high buffers. Insurers typically allocate capital to products when assessing which products and related investment strategies are viable and how much they need to charge customers. Projecting even lower risk free rates or increasing SCR for interest rate risk shocks can have significant negative impacts including hindering insurers' ability to offer products with long-term guarantees and pushing them to shift risk to policyholders.

On impact assessment:

It is vital to **fully understand and measure the cumulative effect of policy options** (capital and operational costs) **at jurisdictional and aggregate EU level** and against both **normal and stressed market conditions.**

Detailed response

Introduction

The EC Inception Impact Assessment correctly identifies many of the problems and issues of the Solvency II review and Insurance Europe supports many of the objectives and policy options proposed. However, there are some important omissions and some refinements necessary to ensure the review achieves the right outcomes.

Solvency II is an economic, risk-based framework. It is strongly supported by the industry but is excessively conservative. Some specific elements need improvements and refinements, in particular relating to the treatment of long-term products and investments. **The Solvency II review should not lead to an increase in capital requirements and, for certain products, a better reflection of the real risk will even lead to a justified release of capital. This outcome is necessary for insurers in order to continue to provide long-term products, including those needed for old-age security, and to fulfil their role of risk coverage for private households and businesses, supporting the economy in recovery, sustainable growth and transformation to a net-zero carbon economy.**

Solvency II currently has a number of measurement flaws and excessive operational burdens that create unnecessary costs and barriers. Focused improvements are needed to ensure the insurance industry can:

- provide a diversified and affordable choice of protection and savings products — including guaranteed life and pension products;
- support recovery and economic growth within and across the EU;
- be the source of capital for long-term and sustainable investments; and,
- continue to be competitive internationally.

The Solvency II review must be regarded in the context of the broader economic and environmental reality, and the ambitions that have been set out by the EU in flagship initiatives such as the European Green Deal, European Economic Recovery Plan and Capital Markets Union (CMU). By addressing the measurement flaws relating to long-term business and investment and reducing operational burden, the Solvency II review will remove existing barriers and allow insurers to make their full and significant contribution to these vital European initiatives.

Proposals for change should be evidence-based and take into account the following:

- EIOPA's assessment of insurers' failures and near misses concluded that few occurred, of which most started before SII was implemented and were caused by poor risk-management practices that are no longer allowed under SII. SII's main purpose is policyholder protection and few policyholders have been adversely affected since SII came into force. So, evidence tells us that increasing the SII capital load is not justified.
- The IAIS recognises insurers' stabilising power. Traditional insurance business was never involved in the channelling and amplification of systemic risk. Therefore, evidence tells us that burdensome and/or costly new systemic risk tools and requirements are not justified.
- SII was deliberately calibrated at a 1/200 confidence level, meaning that some insurers are expected to fail each year because a zero-failure regime is simply too expensive for consumers.
- SII is designed to provide customers and their advisors with information about insurers (solvency positions, etc).
- The unintended consequences of measurement flaws and overly onerous regulation must be considered. Potential unintended consequences to consider include:
    - higher costs for customers;
    - a shift away from guarantee business to unit-linked;
    - a shift towards short-term products, reducing capacity for long-term investment; less capacity and/or interest in equity, SMEs, infrastructure and sustainable investments;
    - a shift away from health insurance in some markets;
    - an absence from the market of smaller insurers and of new insurers entering the market;
    - reduced capacity and interest in risk-taking and a shift of those risks back to consumers;
    - and a reduced ability to act in a countercylical way and pressure to act procyclically.

Key messages

With respect to the proposed objectives of the review:

1. Insurance Europe supports the EC's first objective of facilitating insurers' ability to offer **long-term** life and pension products with guarantees and to contribute to the long-term financing of the economy. Mitigation of the **artificial impact of short-term market volatility** is indeed key for this. Nevertheless, **two further elements should be explicitly mentioned**: **ensuring insurers' liabilities are not exaggerated,** especially long-term liabilities**,** and **ensuring capital charges for investments are appropriate**.

   Exaggeration of liabilities creates barriers for insurers: it unnecessarily reduces own funds and therefore reduces risk-taking capacity; it unnecessarily increases the cost of offering products; and it increases charges to customers and/or limits the availability of products and investments. This holds particularly true in the current low/negative interest rate environment, in which it is especially important not to unreasonably make Solvency II's risk-free-rate projections even more conservative.

   The current solvency capital requirements (SCR) for equities, bonds and property are too high relative to the real, long-term risks for insurers who invest in them. This creates unnecessary disincentives for insurers to invest and affects investment in SME equity and debt.

   Addressing the artificial volatility and the exaggeration in liability valuation in the Solvency II measures and ensuring appropriate capital charges for investment risk are vital to facilitate insurers' ability to play a key role in society by offering long-term life and pension products with guarantees and by contributing to the long-term financing of the economy, in line with the Recovery Plan, CMU and Green Deal objectives.

   Insurance Europe notes that this is very much in line with the recommendations of the High-Level Forum on the CMU which, in relation to Solvency II, included:

   - "Better considering the long-term nature of insurance business and assessing 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."
   - "Assessing whether the risk margin is too high and volatile for its policy purpose, reducing capacity for investment risk in capital markets."
   - "Ensuring that insurers' own funds are appropriately valued and are not too volatile, in particular looking at what improvements can be made to the Volatility Adjustment to avoid exaggerating in either direction the valuation of projected long-term liabilities and reduce artificial volatility."

   The High-Level Forum rightly further notes: "It is also important to avoid other changes to the prudential framework which could increase artificial volatility, exaggeration of liabilities or procyclicality. One area of concern that has been raised in this respect is the potential plans to change how the risk-free curve is extrapolated."

2. Insurance Europe supports the EC's second objective **of expanding and improving the application of proportionality**. Well-implemented proportionality is key to reducing the unnecessary burden for companies, preserving a diversified market and giving room for digital and green innovations within the sector. In particular, a clear focus on the materiality of the underlying risks — and not on the scale of companies — when granting proportionate measures is very important. Hence, low risks need appropriate regulation not only in theory, but also in practice.

3. With respect to the EC's third objective, Insurance Europe supports a level playing field and strong policyholder protection across Europe. However, there is no need for an objective to enhance protection in the case of a possible failure, because Solvency II, when implemented appropriately, already offers very high and sufficient levels of protection. Instead of new measures, the objective should be about

ensuring that Solvency II is applied appropriately in all member states and that there is coordinated supervision of FOS/FOE.

The application of the Solvency II framework since 2016 has helped to ensure that the already high standards of risk management and policyholder protection applied by the vast majority of insurers is now applied by all and across Europe. The long-lasting benefits of Solvency II in this area should not be underestimated.

4. With respect to the EC's fourth objective, it should be recognised that **systemic risk** is limited for the insurance sector and Solvency II is already a comprehensive supervisory framework. In terms of **strengthening financial stability, only very limited new requirements are needed.** The focus should be on selective improvements to the existing framework, avoiding procyclicality.

5. The EC's fifth objective to "provide appropriate incentives" to address **climate change** should be achieved by **removing the barriers to investment** described under the first objective and not through non-risk-based reductions in capital requirements.

   Insurers are already helping to address climate change in a number of ways, eg prevention and adaptation, loss protection/compensation. The industry is also at the forefront of long-term, sustainable financing of the economy, but its activities are limited by the barriers created by Solvency II (noted under the first objective) and the lack of sufficient sustainable and green investments.

   Therefore, the review of Solvency II should not be used to *incentivise* the green transition, but rather to ensure that its design and calibration do not harm insurers' key role in the transition. If Solvency II barriers are removed, insurers' own natural interest and business model, combined with the EC's powerful set of regulatory initiatives (SFDR, the Taxonomy, review of the NFRD) and the wider European Green Deal, will ensure this process continues and accelerates.

In addition, **the following objectives should be added** in the context of the Solvency II 2020 review:

6. Ensuring the **international competitiveness of the European industry** should be included as an objective for the review. This would be in line with the broader objective of the European Commission to "promote Europe's competitiveness on the global stage".

7. **Simplifying and streamlining reporting requirements** should be included, to ensure alignment with the EC's objective with its fitness check of supervisory reporting requirements.

With respect to the policy options:

1. In relation to **long-term financing and long-term guarantees**, Insurance Europe would like to stress that:
   - Under the proposed policy options, the potential that the Solvency II review results in a justified and needed reduction in overall capital requirements should be made clear. There is considerable concern that parts of the current framework are currently **overstating the valuation of long-term liabilities, and some capital requirements, as well as creating artificial balance sheet volatility**. Fixing a limited number of flaws in Solvency II would lead to an overall reduction in capital requirements without compromising the desired level of security. This is justified based on a more appropriate measurement of the risks, but also vital to allow and encourage insurers to invest more in assets of key importance for the European economy. These include SMEs, infrastructure and sustainable investments. Such an outcome, in which there is a justified overall improvement in solvency ratios, should be explicitly considered. In any case, it is key to maintain insurers' ability to play their role across different markets, and changes that would deter national markets' ability to offer long-term products and to make long-term investments due to material deteriorations in overall solvency positions should be avoided.

- Solvency II's existing core principles, including the **going concern** principle, should be restated and reinforced. Changes should be assessed against this principle.

2. **Proportionality** is key to decreasing costs and allowing efficient and effective regulation while maintaining the high level of policyholder protection. In particular, reducing unnecessary regulatory costs for low-risk companies increases investments and improves competitiveness. Also, proportionality supports a risk-sensitive and more effective supervisory regime that additionally fosters the level of security for policyholders. Against this background, Insurance Europe supports the EC option to introduce provisions to make some proportionality rules automatic when certain clear risk-based criteria are met. This should be complemented by provisions making it a duty for NSAs to always consider the application of proportionality when enforcing the Solvency II rules. In addition, NSAs should be obligated to provide measurable goals for the application of proportionality and report regularly about their progress.

3. In relation to the **level playing field and consumer protection**, the industry welcomed the recent changes made in the ESAs review to improve coordination, cooperation and exchange of information between supervisors in the context of FOS/FOE. Insurance Europe believes that the focus should be on a better application of the current rules, including the recent provisions. Material new layers of regulation, such as harmonisation of IGS at European level, are not appropriate and would create significant costs and involve complex challenges for which there may not be acceptable solutions. Instead of harmonising national IGS, the national authorities should be allowed flexibility to choose the features that best suit their market.

   If new instruments or measures for recovery and resolution are to be implemented, they should only apply in a proportionate way to companies for whom they would create a tangible benefit in terms of reduction of material systemic risk at EU level. Furthermore, new instruments or measures should focus on the supervisory layer following a breach of the SCR.

4. In relation to **systemic risk**, the focus should be on targeted improvements to the current framework, as there are a number of counterproductive effects of the current design of Solvency II (eg regarding the VA) that could potentially result in some procyclicality in extreme market situations. Regarding new measures, these should be limited to an implementation of the IAIS holistic framework agreed by European NSAs, and in any case should not go beyond the scope of the EC call for advice. Additional requirements would put European market players at a competitive disadvantage on the global stage.

5. In relation to **climate change**:
   - The Solvency II framework already allows the integration and measurement of sustainability risks. In fact, financially material sustainability risks can be taken into account where appropriate in risk management, the own risk and solvency assessment (ORSA) and the decision-making of the administrative management or supervisory board.
   - The industry does not support artificial incentives/disincentives on the basis of green/brown qualifications, nor the option to introduce lower capital requirements for "green" investments. Maintaining the risk-based nature of Solvency II is key.

6. In relation to **international competitiveness**, major European players traditionally have a significant business presence outside the borders of the EU, and therefore depend on an effective and efficient supervisory system that supports this global presence. From a global regulatory level playing field perspective, Solvency II is extremely conservative. This is in part due to the flaws in the measurement of long-term business, but it is also due to the overall approach to calibration. It is also operationally a very costly framework. Other jurisdictions appear to have taken much greater account of the special characteristics of insurers' long-term business model, as well as their economic and social goals, in the design and calibration of their regulatory frameworks.

While a robust regulatory framework is vital for a trusted, healthy and well-functioning insurance industry, exaggerating its conservativeness harms European competitiveness on the global stage and therefore acts against the EC's ambition.

7. In relation to **reporting and disclosure**, Insurance Europe strongly supports the EC's broader objective of identifying areas in which there is scope to simplify and streamline reporting, as set out in the fitness check of supervisory reporting requirements. In addition, the industry supports further streamlining the requirements and developing supervisory reporting that is fit for the future, by, for example, removing significant parts that have proven not to be used and clearly focusing on the needs of the respective recipients.

With respect to the preliminary assessment of likely impacts:

1. In relation to the likely economic impacts of any changes to interest rate methodologies:
   - Because on average insurers' levels of own funds are more than twice as high as what is required, the EC indicates that increasing capital requirements by making changes to interest rate calibrations/methodologies would not hinder insurers' contribution to the long-term financing of the economy. This is wrong.
   - It should first be noted that changes in interest rates, including if they become negative, are already immediately reflected in the valuation of insurers' assets and liabilities under Solvency II. The risk free rate methodology used as part of liability valuations is already conservative enough and should not be changed. For example, the euro risk-free rates in Q1 2020 were respectively -0.12%, 0.12% and 1.49% for years 10, 20 and 40, and so already reflect the current protracted low-yield environment. It is recognised that some change is justified for the current solvency capital requirement (SCR) to cover the risk that interest rates go even lower because it does not currently allow for negative rates. However, care must be taken in setting an appropriate and plausible "floor" for how negative interest rates can go. If the floor is set at excessively negative rates, this will have an adverse impact on current and future insurance products and investments.
   - It is important not to assume that because an insurer can "afford" an increase in capital requirements without having to raise more funds, the absolute level of capital does not matter. Insurers will typically allocate capital to products when assessing which ones are viable and how much they need to charge customers (based on the liabilities and investment strategies for assets backing those liabilities). Lowering risk free rates even further or increasing capital charges for interest rate risk shocks can have a significant negative impact on products and investments, especially those relating to long-term products and those with guarantees.
   - It is also important to recognise that the current artificial volatility in the balance sheet created by the SII measurement is one of the reasons why insurers often see the need for very high buffers.

2. In relation to likely social impacts:
   - The initiative rightly aims to tackle the problem of excessive volatility in insurers' solvency position, which may hinder insurers' ability to offer products with long-term guarantees and may incentivise them to largely shift the risk to policyholders.
   - For any proposed changes, it should therefore be carefully considered whether it would help to mitigate this problem or whether it would even exacerbate it. This should, in particular, include gathering information on how the supply of long-term guarantees would be reduced if there are changes to the extrapolation of the risk-free interest rate term structure.

With respect to the EC impact assessment:

Looking ahead, it is imperative that the capital and operational costs of any policy options considered by the Commission are comprehensively understood. The cumulative effect of policy options, at jurisdictional and aggregate EU level, should be measured, against both normal and stressed market conditions. While EIOPA is testing proposals against end-2019 and Q2-2020 data, it is worth noting that:

- Testing against Q1-2020 data would have provided additional insights for some member states.

- Especially with respect to mitigating market volatility, assessing the impacts under extreme conditions such as the 2011 sovereign crisis or the 2008 financial crisis is also necessary.

Insurance Europe will provide further details in relation to the above-mentioned points in its response to the European Commission public consultation on the Solvency II review.

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