



SOLVENCY II REVIEW: FOR A SUSTAINABLE AND COMPETITIVE EUROPEAN ECONOMY



**French Insurance
Federation**

EUROPE IS SEVERELY CHALLENGED

The crisis we are collectively facing has shed light on the **need to build a more resilient society and a more sustainable economy to meet the current challenges**: economic recovery, negative interest rates, ageing population, and climate change.

The European Union (EU) set **key priorities** (carbon neutrality, better access to financing for companies, etc.) backed by ambitious policy

initiatives (European Green Deal, Capital Markets Union, Recovery Plan for Europe) that **French insurers fully support**.

Thanks to their capacity to finance the economy and their long-term business model, insurers can contribute to these strategic objectives, providing **that regulation helps them to achieve it**.

IN THIS CONTEXT, THE SOLVENCY II REVIEW IS THE OPPORTUNITY TO PROMOTE A SUSTAINABLE AND COMPETITIVE EUROPEAN ECONOMY

In December 2020, the European insurance supervisor (EIOPA)¹ has submitted to the European Commission its Opinion on the ongoing Solvency II 2020 Review. The European Commission's proposals are expected to be published in Q4 2021.

The French Insurance Federation (FFA) believes that **many proposals from EIOPA appear disputable not only in terms of efficiency, but also in terms of need and impact**.

Considering today's challenges that Europe is facing, FFA believes that the review of Solvency II is the opportunity to go further in promoting a sustainable and competitive European economy.

To achieve that, the review shall address three key objectives:

- 1 • Strengthening the social and economic role of insurance: because they invest in businesses over the long term, insurers contribute significantly to the transition towards a sustainable economy.
- 2 • Enabling insurers to better support investments and offer long-term products (life insurance, pension insurance, nursing-care insurance) to provide consumers with a diversified choice of insurance products but also to tackle the major challenges our society is facing, such as the demographic transition and climate change.
- 3 • Enhance the French and European insurance industry's global leadership and attractiveness.

¹ European Insurance and Occupational Pensions Authority.

THE SOCIAL AND ECONOMIC ROLE OF INSURANCE

Insurance is everywhere in our economies and plays a major social and economic role.

- Insurance **protects people and businesses** against the hazards of life and allows them to **invest and innovate**. Therefore, contributing to economic growth and boosting employment. Benefits paid to policyholders allow them to continue to live their lives as normally as possible after a loss (rebuilding of their fire-gutted home, replacement of their stolen vehicle, etc.), to access to medical treatment (financing of a treatment in case of illness), to benefit from an additional income during retirement years, or even to protect their loved ones in case of death (payment of a lump sum or annuities to beneficiaries).
- Thanks to the reversed production cycle and to the long-term perspective, which characterise insurance's business model, **insurers are major players in the financing of the economy**.
- Insurers risk knowledge enables them to play a key role in **risk prevention** (motor, health, natural disaster risks, etc.)

- INSURERS PROTECT -

In 2020, life insurance is:



38 million

of beneficiaries of a life insurance contract in France



€123bn

of benefits paid



1/2

Proportion of farmers, corporate executives or pensioners with a life insurance policy. This figure is 1 in 3 for craftspeople, merchants, business leaders or intermediate professions and 1 in 4 for workers

In 2020, French insurers have managed almost 12 million claims:



Or more than

32,600 claims per day in property-casualty insurance (motor, home, business), for a total amount of **€43bn** over the year

Insurers contribute to risk prevention



€32.9 million

invested by French insurers into road risks prevention² in 2019

²Assurance Prévention.

- INSURERS INVEST -



Over

€10,000bn

of assets under management **in Europe**. Insurers are the biggest institutional investors in Europe



€1,600bn

invested by **French** insurers in businesses in 2020, representing **60%** of their global investments: **36%** in bonds, **19%** in equities, and **5%** in real estate



Almost **€100bn**

invested in SMEs and intermediate-sized enterprise by **French** insurers in 2020 (+83% over the last five years)

INSURERS ARE COMMITTED TO FIGHT AGAINST CLIMATE CHANGE

Aware of sustainability issues, **insurers take into account the consequences of today's investments not to cause environmental and social imbalances, for which they would have to suffer the consequences tomorrow**. Hence, insurers have a key role to play in contributing to sustainable growth to speed up the transition towards an inclusive and low-carbon economy, but also to build a more resilient society to deal with climate risks.

Insurers also support the transformation of companies and States in which they invest towards ESG practices.

Finally, by offering long-term savings products, insurers enable retail investors to build capital on a significant period of time. As it fosters long-

term financing, combined with a long-term business model, this time horizon is consistent with sustainable development issues. Responsible investment favours, while offering equivalent financial performance, the adoption of the best environmental, social or governance practices.

« To achieve the ambition set by the European Green Deal, there are significant investment needs. The Commission has estimated that achieving the current 2030 climate and energy targets will require €260 billion of additional annual investment, about 1.5% of 2018 GDP. This flow of investment will need to be sustained over time. The magnitude of the investment challenge requires mobilising both the public and private sector. »

(The European Green Deal, December 2019)

GREEN INVESTMENTS³



€92bn of green investments in 2019 (green real estate, green bonds, green infrastructure, dedicated environmental funds, etc.)



+ 51 %

comparison with 2018

EXIT FROM COAL

Over €1.3bn disinvested by French insurers in 2019

ONLY 0.5 %

of assets under management by French insurers are exposed to coal

³ FFA, Assurance et finance durable : Chiffres clés 2019, October 2020.

Insurers' capacity to invest long term relies on their long-term business models, their ability to manage long-term liabilities and to offer long-term products, such as saving and pension products. This offer is already challenged by the negative interest rate environment, which is very likely to last. For insurance to play its economic and social role in our societies, an adequate prudential framework is needed.

FOCUS

Negative interest rates: What is the impact on life insurance?

Considered as the preferred means of investment in France (45% of households have at least one life insurance contract), life insurance is a specific product that combines personal protections with a savings goal. Combining €1,789bn of outstanding life insurance contracts (at the end of 2020) with a long-term management strategy allows insurers to diversify their portfolio of assets to better support the financing of businesses and public infrastructures. 77 % is allocated to the insurer's general funds, for which the capital is guaranteed leading to favouring bond investments, while 23 % is allocated to non-guaranteed unit-linked products where policyholders bear the risk. Insurers manage the risk and performance of their portfolio to the benefit of policyholders, under the liquidity constraint.

Since June 2019, interest rates dropped down to negative territory. In the medium run, persistent low interest rates would have important consequences on life insurance, leading to a steady decrease of the return of insurers' general funds. This context has a significant impact on insurers' solvency, mainly because of the decrease of the risk-free interest rate term structure used for the calculation of technical provisions, as well as on the calculation of the solvency capital requirement (SCR). In this context, insurers might take remedial actions, such as raising capital or opt out from risky assets which are capital-consuming under Solvency II.

FFA'S PROPOSALS TO MAKE THE INSURANCE SECTOR A KEY DRIVER OF THE RECOVERY AND GREEN TRANSITION

FFA is convinced that the Solvency II review offers the opportunity to go further in promoting a sustainable and competitive European economy. It outlines in this paper its proposals to ensure that this review fully contributes to these objectives.

1 - Strengthening insurers' ability to contribute to sustainable economic growth for innovation and employment, in line with the European objectives of the Capital Markets Union and the economic recovery

In Solvency II, the risk margin has been designed to facilitate the transfer of liabilities to a third party in the event of default. It is therefore an estimate of the costs of transferring the insurer's portfolio. This risk margin currently represents an excessive capital buffer for insurers (more than 12% of French insurers' own funds or €36bn in 2020, and €190bn at European level), not to mention its high sensitivity to interest rates. By putting forward measures to reduce the burden of this additional buffer, such as the introduction of a lambda factor in the formula for calculating the risk margin in order to account for the time dependency of risks, EIOPA recognises its excessive amount. These approaches should be further explored in a context where life insurers are already challenged by negative interest rates.

FFA proposal

In this respect, a reduction of the cost of capital – used to calculate this risk margin – from 6% to 3% would increase French insurers' own funds

by €6bn⁴, resulting in an increase of insurers' risk-taking capacity, without jeopardising consumer protection.

At this time, insurers investment in the real economy and in infrastructure could be increased by reducing the constraints on these investment classes. The capital charge that needs to be blocked for equity investment is between 39% and 49% of that investment.

These constraints are acknowledged by the European Commission in its new Capital Markets Union Action Plan, which aims to support the re-equitisation of the economy by encouraging institutional investors, such as insurers, to make more long-term investments.

« The participation of insurers in long-term investments, in particular equity, can be supported by ensuring that the prudential framework appropriately reflects the long-term nature of the insurance business and mitigates the impact of short-term market turmoil on insurers' solvency ».

(European Commission, A capital markets union for people businesses; New Action Plan, 24 September 2020).

Insurers have welcomed the review of the Solvency II Delegated Regulation in 2018, which saw the creation of a new class of long-term equity investments (LTEI) that allows for a reduced capital charge, to better reflect insurers' long-term management strategy.

⁴ Impacts are calculated based on France Vie, a simplified model of the French market developed by Milliman, as at June 30, 2020.

FFA proposal

However, the criteria to be met for LTEIs are too restrictive. As a result, this specific provision is today largely unused, both at French and European level. In its opinion, EIOPA proposes to improve some of these criteria. FFA would welcome a deeper review of the criteria for using this asset class (extension of eligible investments from the EEA to the OECD area, relaxation of the assessment of the ability to avoid the forced sale of these assets, etc.), in order to encourage a wider use of this provision.

The volatility adjustment (VA) was introduced in the regulation in 2014 to avoid pro-cyclical investment behaviour of insurers in case of decreasing bond prices. By allowing the adjustment of the risk-free rate for the calculation of technical provisions, the VA ensure a better economic valuation of insurers' long-term liabilities. This adjustment is widely used in Europe (79% of technical provisions in Europe are calculated with the VA) and especially in France (over 90%)⁵. Overall, the VA works well for companies.

Nevertheless, the recent crisis has shown a high artificial volatility on the solvency ratio of insurers. It needs to be fixed.

The volatility adjustment is calculated on the basis of a general ratio of 65%, applied to a representative portfolio of assets in which insurers have invested at European level. Unfortunately, EIOPA's proposals will not only make the VA more complicated, but also more procyclical, in particular if changes are applied to the risk correction.

In addition, to recognise the illiquidity characteristics of insurers' liabilities, EIOPA proposes to apply a liquidity ratio to the volatility adjustment, based on a categorisation of the liabilities which aims at capturing the stability and predictability of future flows. This would not result in a proper consideration of the risk of forced

sale of assets, and would also complicate the use of the VA.

EIOPA's proposals tend therefore to make the VA more complex. This should be avoided, especially since this complexity is not offset by a better efficiency of the VA in times of stress, when insurers need it the most.

FFA proposal

To address these issues and improve the efficiency of the VA, FFA suggests to not change its actual design but to increase the general application ratio from 65% to 100%. This will lead to a better adjustment in times of stress, consequently limiting procyclical effects.

However, for standard formula users applying the VA, the spread SCR is not based on a complete recalculation of assets and liabilities taking into account the effects of this measure. Instead, the current methodology applies the extreme spread shock scenario only to the assets and ignores the offsetting impact of the volatility adjustment on the value of the liabilities. This flaw means the true economic impact of that scenario is not correctly measured and results in significant over-estimation of the spread risk, particularly for long-term business.

FFA proposal

FFA suggests considering the dynamic VA (DVA), applied by internal model users, to fix this issue. This would allow to take into account changes resulting from the volatility adjustment in the context of shock scenarios on spreads. In this way, the VA applied for the valuation of liabilities would be consistent with the spread scenarios used to value the assets. To take into account the DVA for standard formula users, FFA recommends applying to

⁵ EIOPA, *Report on long-term guarantees measures and measures on equity risk 2020*, December 3, 2020.

the spread SCR a reduction factor reflecting in a simplified way the economic impact of the DVA.

parameters for extrapolating the risk-free rate curve.

The application of this method to companies using the standard formula would not only help to further reduce the artificial volatility of the prudential framework, it would also have a significant impact on capital requirements (decrease of €18bn). This method could counterbalance other measures, such as the consideration of negative interest rates in the calculation of the SCR. It could also allow insurers to invest more in the economy to further contribute to the objectives of the EU.

Because insurers are already challenged, reflecting negative interest rates in the standard formula should not be artificially prudent. As proposed by EIOPA, it would lead to a €21bn increase of the capital requirement for French insurers, hampering the ability of insurers to invest in the economy. In addition, these changes would make long-term products more costly, which could lead market players to divest from riskier asset classes or a decrease in products offering, whereas the context of an ageing population⁶ would require the opposite.

2 - Enabling insurers to provide consumers with a diversified and affordable choice of long-term insurance products to address the challenge of demographic ageing

In Solvency II, the risk-free interest rate curve is used for the economic valuation of insurers' liabilities. Given the long-term duration of these liabilities, this curve has a significant influence on the solvency ratio of the insurance company. This curve is extrapolated for when the market is considered not liquid, deep and transparent enough. Changing the current methodology and parameters for **extrapolating the risk-free rate curve**, as proposed by EIOPA, would have significant consequences and would particularly impact capital charges for long-term products which are more costly. The forecast impact would be a decrease of €11bn in French insurers' own funds and an increase of the SCR of €5bn.

FFA proposal

FFA acknowledges the need to take into account the context of **negative interest rates** in the Solvency II framework. However, in the current context of economic recovery the impact on capital charges of such a measure must be offset to avoid undermining insurers' capacity to invest in the real economy and to offer long-term products to consumers. .

3 -Preserving the competitiveness of the European insurance sector to ensure Europe's attractiveness and the proper functioning of the internal market

FFA proposal

Given the significant impacts and the lack of substantial economic justification, FFA recommends not to change the current methodology and

Solvency II has proved successful thanks to the implementation of an adequate governance and risk management model to better understand the risk profile and the real economic losses of the company. It guarantees a high level of protection of policyholders. However, Solvency II remains complex. This is a burden for businesses and has a cost for policyholders. This review

⁶ Eurostat, 2020.

is the opportunity to reduce unnecessary operational costs by simplifying, or even alleviating, several **financial reporting** requirements.

FFA proposal

While a number of EIOPA's proposals, such as extending the deadlines for annual reporting or publishing a single Regular Supervisory Report (RSR) for groups, go in the right direction, the addition of an audit requirement for the Solvency and Financial Condition Report (SFCR) and of more reporting requirements should be reviewed.

Solvency II being already complex, it is important not to increase this complexity. However, EIOPA's proposals on the VA or on the extrapolation of the risk-free yield curve will. A more complex framework will have negative consequences on insurance companies as well as on consumers.

To avoid a disproportionate burden on companies, Solvency II provides for a proportional risk-based application of several requirements, especially for small players. Unfortunately, in practice **proportionality** is hardly applied by national supervisory authorities. In this regard, EIOPA proposes to strengthen its effectiveness through the creation of a low-risk class of companies which could benefit, among other things, from a relief in reporting and governance requirements as well as automatic simplifications for the calculation of the SCR and technical provisions.

FFA proposal

FFA supports EIOPA's proposals on proportionality. However, the criteria for applying this low-risk business class are too restrictive and the application process should not be too burdensome for small businesses. In addition, FFA supports the inclusion of proportionality

in the Solvency II Directive as a duty for national supervisory authorities.

A proper understanding and a sound application of Solvency II is of utmost importance to guarantee compliance with the European prudential framework. In this regard, the recent failures of insurance companies operating under **the freedom to provide services (FoS)**, from their "home-country" to a "host-country", have shown the need to foster the implementation of the prudential framework to ensure the proper functioning of the single market and, ultimately, adequate protection for policyholders. FFA welcomes progress that has been made in the 2018 review of the European system of financial supervision and supports several EIOPA's proposals: on exchange of information; on enhancing EIOPA's role in the cooperation platforms between national supervisors; on the introduction of a European network of national **insurance guarantee schemes (IGSs)** to address companies' failures.

FFA proposal

FFA supports the creation of a guarantee fund, for failures, in each Member State. This fund must at least cover cross-border activities of insurance companies registered in that country (home country control principle). However, each Member State should be free in setting up and organising the financing of its guarantee fund. A ceiling must be determined so that the financing of the fund does not impact the solvency of market participants. In addition, companies operating under FoS in a different Member State from where they are registered should demonstrate a clear understanding of the risks they intend to cover, so does the supervisor.

While overall some proposed changes look reasonable and might address flaws, **many suggestions of EIOPA appear disputable, not only in terms of efficacy, but also in terms of need and impact (increasing volatility and complexity, reducing the risk-taking capacity of the industry)**. FFA believes that EIOPA's proposals would result in a sharp fall of French insurers' solvency ratio (- 41 basis points). Furthermore, the proposed macro-prudential measures also seem disputable as systemic risk remains limited. If necessary, tools to prevent it already exist in Solvency II.

A more conservative and complex prudential framework would not only harm the competitiveness of the European

industry but would also hinder the capacity of the insurance industry to fully fulfil its roles in financing the recovery and the transition towards a sustainable economy. Even through the recent crisis that it faced, the industry demonstrated its solidity⁷, and therefore, the solidity of the Solvency II prudential framework.

That is why the FFA supports a targeted review of Solvency II, based on a holistic and long-term perspective, to allow insurers to fully contribute to the European challenges and to strengthen the EU's competitiveness at global level.

⁷ 239% SCR ratio in France and 226% in Europe in June 2020.



26 Boulevard Haussmann
75009 Paris

Rue du Champ de Mars 23
1050 Bruxelles

ffa-assurance.fr

 @FFA_assurance