EIOPA OPINION ON SOLVENCY II REVIEW: CONCERNS OF AAE

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This article is a summary of the official AAE Position Paper

In February 2021, the Actuarial Association of Europe (AAE) set out its main positions regarding the Solvency II 2020 review.

While acknowledging that Solvency II is intrinsically a well-functioning, risk-based framework, the AAE believes that the experience of the past five years of application, along with the low interest environment, reveal a need to change parts of the current framework.

The overall aim is to ensure policyholders protection and financial stability in Europe, and as such it is important not to change the fundamental principles of the Solvency II framework, such as confidence level underlying calibration of capital requirements or the market-consistent basis for the valuation of the balance sheet.

However, the primary demand for the insurance sector to better serve the long-term needs for European citizens and to act as long-term investors requires an appropriate valuation of long-term business and a risk-adequate treatment of long-term investments as well. It is a requirement that such a valuation aims at reducing volatility and thus prevents procyclical behaviour. An appropriate valuation of the obligations resulting from the contracts in a portfolio is indispensable.

Solvency II together with the Long-term guarantee (LTG)-measures has worked well in terms of safeguarding the policyholders in the past and should not be jeopardised by inappropriate new requirements. Our main concerns are related to: the treatment of long-term business with guarantees;

the enabling a well-diversified, sustainable and persistent investment strategy; and the proposed extensions of the Solvency II framework by macroprudential elements.

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An identified last liquid point (LLP) is the starting point for an extrapolation. Currently, for the Euro, this LLP is 20 years and should not be changed, as that would have a significant market impact which needs to be taken carefully into account.

Another essential criterion is the requirement to reach the Ultimate forward rate (UFR) within a given convergence period (currently 40 years for the Euro) with a given tolerance. This UFR reflects a long-term expectation or a mean-reversion level, annually determined by EIOPA in accordance with the method published in 2017.

The alternative extrapolation method proposed to the European Commission leads to a significant weakening of the role of the UFR caused by waiving the convergence requirements. Convergence to the UFR is determined by the last liquid forward rate (LLFR) and a mean reversion factor alpha, which is – without scientific justification – set to 10%. The LLFR aims to take into account information from DLT-markets post-LLP and is the starting value for the extrapolation. It can be highly volatile and affects the entire RFR. Convergence is modelled independent from capital markets by applying fixed factors depending solely on the mean reversion factor. Therefore the method cannot compensate short- or mid-term distortions of capital markets (e.g. resulting from ECB-activities, Covid-19). These are carried forward to the entire RFR and thus increase volatility of undertakings' capital position.

Particularly in a low interest rate environment a more volatile and significantly lower risk-free rate, might prevent insurers from maintaining their long-term business model, holding long-term investments in a sustainable way and offering products with guarantees.

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Volatility adjustment needs reconsideration. EIOPA's proposal is still based on a reference portfolio calibrated on EU-level. Considering undertaking specific aspects in the ALM and liquidity application ratios plus a quicker and smoother activation of the country component aims at better consideration of undertakings risk. It leads to a higher degree of complexity, but this will not remedy the identified deficiencies on over or undershooting resulting from differences between own assets and the reference portfolio. Taking own assets as a basis should still be definitively part of the Risk Management System and ORSA exercise.

In terms of interest rate stress, we see the need for corrections, as currently no stress is applied to negative interest rates. Considering the one-year horizon required by Solvency II, risk parameters should only be applied to the liquid part of the extrapolated curve. This stressed liquid part should be extrapolated. First stress – then extrapolate!

We welcome the attempt to reduce the risk margin by introducing a factor lambda to attenuate the impact of future SCR. The proposed floor should be omitted as the margin needs further analysis, especially on the way it works for long-term insurance liabilities.

Same risk, same capital is a basic principle of Solvency II. Therefore neither green supporting, nor brown penalising factors should be introduced. Capital requirements should consider the quality of investments and the inherent risk.

Solvency II is a risk-based – although microprudential – framework, and EIOPA acknowledges that risks for financial stability, liquidity risk, etc. in insurance are not comparable to those observed in banks. Any extension of Solvency II should be based on a thorough analysis of current options. With regard to recovery, resolution and IGS, different treatments across Europe could lead to flaws in policyholder protection. Harmonisation should consider cross-border business, already available solutions and proportionality aspects.

Coherence of the Solvency II framework should be considered. Additional burden for the undertakings resulting from macroprudential measures to reduce risk should be assessed together with the existing prudential framework in order not to go beyond the current 99.5% VaR requirement.

In short, the Solvency II review, should aim for an appropriate valuation of long-term liabilities but also offer better possibilities to support a sustainable relaunch of the EU economy in the aftermath of Covid-19. We must also ensure that new, emerging risks are properly considered. But the focus must remain on policyholder protection and the prevention of insolvency risk – it is important not to overstretch Solvency II and to preserve it as a principle-based framework.

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