ACTUARIAL ASSOCIATION OF EUROPE

Solvency II

Committee Meetings

Campus Sursee

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SII-Review: Legislative Steps

TFEU (Treaty on the functioning of the EU) and **EIOPA Regulation** (EU) **1094/2010** constitute the legal basis

European Council

European Parliament

European Commission

SII-Directive is a Level 1-document in the hierarchy of the framework. Adaptations have to be approved by the trilogue parties.

After approval it has to be transferred to national law in all member states.

In addition, amendments of Delegated Regulation, Regulatory technical standards or Guidelines might be required.

Next steps

The Commission therefore calls on the European Parliament and the Council to advance swiftly in inter-institutional negotiations on the amendments to Directive 2009/138/EC – and the creation of a resolution framework for insurers.

https://ec.europa.eu/finance/docs/law/210922-communication-solvency-2_en.pdf

Who is in charge?

Next Steps: Slovenian presidency expected to steer the process (at least until end of 2021). France will follow in 2022.

Every six months a different member state holds the presidency of the Council of the European Union. The presidency rotation takes place on 1st January and 1st July each ear.

Each Presidency works closely with the two other member states: the one that preceded it and the one that will follow it. This partnership is known as the 'trio Presidency'.

https://www.consilium.europa.eu/de/documents-publications/library/library-blog/posts/the-presidency-of-the-council-of-the-eu/

Expected: European Parliament to name a rapporteur and to set up a negotiating team.

Timeline for implementation

EIOPAs Opinion 17 December 2020

Report of the EU-Commission:
22 September 2021

Discussion with trilogue-parties as of September 2021

Amendment of Directive agreed: 2022 (?)
→ Transfer to national law within 18 months

Entering into force 2023 (at the earliest)

In case additional impact assessments were required
→ deferral

Solvency II 2020 review - agenda

1) Commission's proposals - overview
2) Amendment of LTG-measures
3) Amendment of risk-management requirements

Commission’s proposals - overview

Published on 22 September:

Proposal for an amendment of the SII Directive
https://ec.europa.eu/finance/docs/law/210922-proposal-solvency-2_en.pdf

Proposal for a directive dealing on recovery and resolution
https://ec.europa.eu/finance/docs/law/210922-proposal-insurance-recovery-resolution_en.pdf

A communication document summarising the content of both proposals.
https://ec.europa.eu/finance/docs/law/210922-communication-solvency-2_en.pdf

Q&As:
https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_4764

An executive summary of the impact assessment report:
https://ec.europa.eu/finance/docs/law/210922-summary-impact-assessment_en.pdf

SII 2020 review – Commission's proposal

Issues covered:

1) **Proportionality**
2) Quality of supervision
3) **Reporting**
4) **Long-term guarantee measures**
5) **Amendments related to the European Green Deal**
6) Group supervision
7) Supervision of cross-border insurance business
8) **Transitional measures introduced by Directive 2014/51/EU**
9) Minor updates and fixes

Summary – Impact assessment

https://ec.europa.eu/finance/docs/law/210922-summary-impact-assessment_en.pdf

What are the benefits of the preferred option (if any, otherwise main ones)?

The combination of preferred options is expected to:

?

- facilitate insurers' ability to fund businesses;
- incentivise insurers to take better account of sustainability risks;
- foster long-termism in insurers' activities, by better mitigating the impact of market volatility;
- enhance policyholder protection by
    i. better incorporating the low-yield environment;
    ii. strengthening coordination and consistency of supervision;
    iii. introducing minimum harmonising rules to mitigate the impact of insurance (near-)failures.
- help preserve financial stability.

The initiative would result in an increase of up to EUR 30 billion in the amount of own funds in excess of capital requirements, <u>depending on market conditions</u>. As the changes that would reduce insurers' solvency ratios would only be gradually implemented over several years, in the short term the initiative would release up to EUR 90 billion of capital that insurers could use to support the economic recovery.

Only high-level regulation in level 1

General remarks

Basically, the EU-Commission follows EIOPA’s proposals provided in the Opinion on the Solvency II-review in December 2020

Important issues are not finally fixed in EIOPA’s proposal

- Shall be subject to upcoming delegated acts

Convincing impact assessment not available

- Only global message concerning overall effects on insurer’s own funds
- Unclear, how impact can be assessed with important questions unanswered

There is leeway in the proposed empowerment concerning delegated acts and ITS.

- **We could strive for an “upgrading” of some issues to level 1**
- **We should be prepared to contribute to the upcoming tasks**

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Long-term guarantee (LTG) measures

LTG-measures have been introduced via the Omnibus II – Directive in order to facilitate an adequate treatment of long-term business.

Article	Name of the measure
77a	Extrapolation of the risk-free interest rate
77b, 77c	Matching adjustment (MA)
77d	Volatility adjustment (VA)
106	Symmetric adjustment to equity capital charge
138(4)	Extension of the recovery period
304	Duration-based equity risk sub-module (DBER)
308c	Transitional measure on the risk-free interest rates
308d	Transitional measure on technical provisions

Symmetric Adjustment, DBER

Symmetric adjustment: value extended from 10% to 17%

In Article 106, paragraph 3 is replaced by the following:

3. The symmetric adjustment shall not result in an equity capital charge that is more than 17 percentage points lower or higher than the standard equity capital charge.

Duration-based equity risk sub-module no longer needed → LTE

No new approvals

Extrapolation: change of methodology

- The relevant RFR shall be extrapolated for maturities longer than the first smoothing point. The **first smoothing point** for a currency shall be the longest maturity for which all of the following conditions are met:
  a. the markets for financial instruments of that maturity are DLT;
  b. the percentage of outstanding bonds of that or a longer maturity among all outstanding bonds denominated in that currency is sufficiently high.

- The extrapolated part of the relevant RFR shall be based on forward rates converging smoothly from one or a set of forward rates in relation to the longest maturities for which the bonds can be observed in a DLT market to an UFR.

- The extrapolated part of the relevant RFR shall take into account **information from financial instruments other than bonds for maturities where the relevant RFR is extrapolated and where the markets for those instruments are DLT.**

Extrapolation: change of methodology

Choice of parameters determining the speed of convergence:

Parameters determining the speed of the convergence of the forward rates towards the UFR of the extrapolation **may be chosen** such that on first application date the RFR is sufficiently similar to the RFR in line with current extrapolation methodology one day before this date.

Those parameters of the extrapolation shall be decreased linearly at the beginning of each calendar year, during a transitional period. The final parameters of the extrapolation shall be applied as of 1 January 2032.

Thus, the RFR extrapolated by means of Smith-Wilson methodology will be approximated by choice of appropriate parameters used in the alternative extrapolation methodology.
Phasing-in independent of pre-defined market conditions (different from "mechanism" introduced in EIOPA's Opinion-paper to compensate for low interest rate environment).

Delegated acts and ITS - Article 86

Article 86 empowers the Commission to adopt delegated acts

In paragraph 1 point (b) is replaced by the following:

(b) the methodologies, principles and techniques for the determination of the relevant RFR to be used to calculate the best estimate referred to in Article 77(2), in particular:

i. the **formula for the extrapolation** referred to in Article 77a(1), including the parameters that determine the convergence speed of the extrapolation;
ii. the **method for the determination of the depth, liquidity and transparency** of bond markets referred to in Article 77a(1);
iii. the **percentage** below which the share of bonds with maturities longer than or equal to a given maturity among all bonds shall be regarded as low for the purposes of Article 77a(1);

The AAE should stand by to engage in these crucial developments.

Volatility adjustment (VA) – Article 77d

Approval required for new applications of the VA, as laid down in new paragraphs 1a and 1b

Ongoing use of currency-specific reference portfolio as basis for the determination of the spread.

Amendments described only in general terms!

Commission should be empowered to adopt delegated acts specifying the calculation of undertaking-specific elements of the VA.

Volatility adjustment (VA) – Article 77d

3. The amount of the VA to risk-free interest rates for a currency cu shall be calculated as follows:

$$VA_{cu} = \mathbf{85\%} \cdot CSSR_{cu} \cdot RCS_{cu}$$

Where:

(a) VA_{cu}	is the VA for a currency cu;
(b) $CSSR_{cu}$	is the credit spread sensitivity ratio of an undertaking for the currency cu;
(c) RCS_{cu}	is the risk-corrected spread for the currency cu.

Delegated acts and ITS - Article 86

The Commission shall adopt delegated acts laying down

(i) methods and assumptions for the calculation of the volatility adjustment referred to in Article 77d, including the following:

i. a formula for the **calculation of the spread** referred to in paragraph 2 of that Article;
ii. a formula for the **calculation of the credit spread sensitivity ratio** referred to in paragraphs 3 and 4 of that Article ;
iii. for each relevant asset class, the percentage of the spread that represents the portion attributable to a realistic assessment of expected losses or unexpected credit or other risks of the assets as referred to in Article 77d(3);
iv. the **transitional mechanism** as referred to in Article 77a(2);

The AAE should stand by to engage in these crucial developments.
Illiquidity is nowhere explicitly addressed in Commission’s proposal.

Transitional measures – Article 308c, 308d

<u>Approval</u> to use the transitional measures only for undertakings

- falling for the first time in the scope of the Directive
- having accepted a portfolio transferred by an undertaking that applied these measures prior to the transfer

<u>Disclosure</u>

Within the part of the SFCR consisting of information <u>addressed to other market participants</u> referred to in Article 51(1b), publicly disclose all of the following:

(i) the fact that they apply the transitional measure;

(ii) the quantification of the impact of not applying the transitional on their financial position;

(iii) where the undertaking would comply with the SCR without application of this transitional measure, the <u>reasons for the application</u> of this measure;

(iv) an assessment of the dependency of the undertaking on this transitional measure and, where applicable, a description of the measures taken or planned by the undertaking to reduce or remove the dependency.

Risk margin

EIOPA proposed to amend the risk margin formula with two additional parameters.

The Commission will consider

- building on **the lambda approach** proposed by EIOPA, but without a floor parameter, to allow for more effective mitigation of volatility than under EIOPA's proposal.

- reducing the **cost-of-capital rate** from 6% to 5%, in line with the reduction in capital cost for insurance and reinsurance companies over the past years.

Overall, these envisaged changes would reduce the size of the risk margin by more than €50 billion across the sector in the EU, increasing the insurance industry's capacity to invest in EU businesses.

Source: https://ec.europa.eu/finance/docs/law/210922-communication-solvency-2_en.pdf

Risk margin: Change of formula proposed

Background

The weight of future SCR is attenuated by application of a factor λ;
CoC-rate remains unchanged

$$\mathbf{RM_{scenario} = CoC \cdot \sum_{t\geq 0} \frac{SCR(t)}{(1+r(t+1))^{t+1}} \times max(\lambda^t, 0.5),\ \lambda = 0.975}$$

- SCR(t): SCR after t years;
- r(t+1): basic risk-free rate for the maturity of t+1 year
- CoC = 6%

This factor λ reduces the risk margin considerably.
Effect comparable to a significant reduction of the CoC –rate.
Size of the factor λ justified by an analysis of the duration of the SCR(t)

Adaptation of formula shall account for the time dependency of the risks

Interest rate risk - considerations

Calculating the capital requirement for interest rate risk

First stress, than extrapolate!
But: stress on UFR, 15bp considered

The Commission therefore will consider

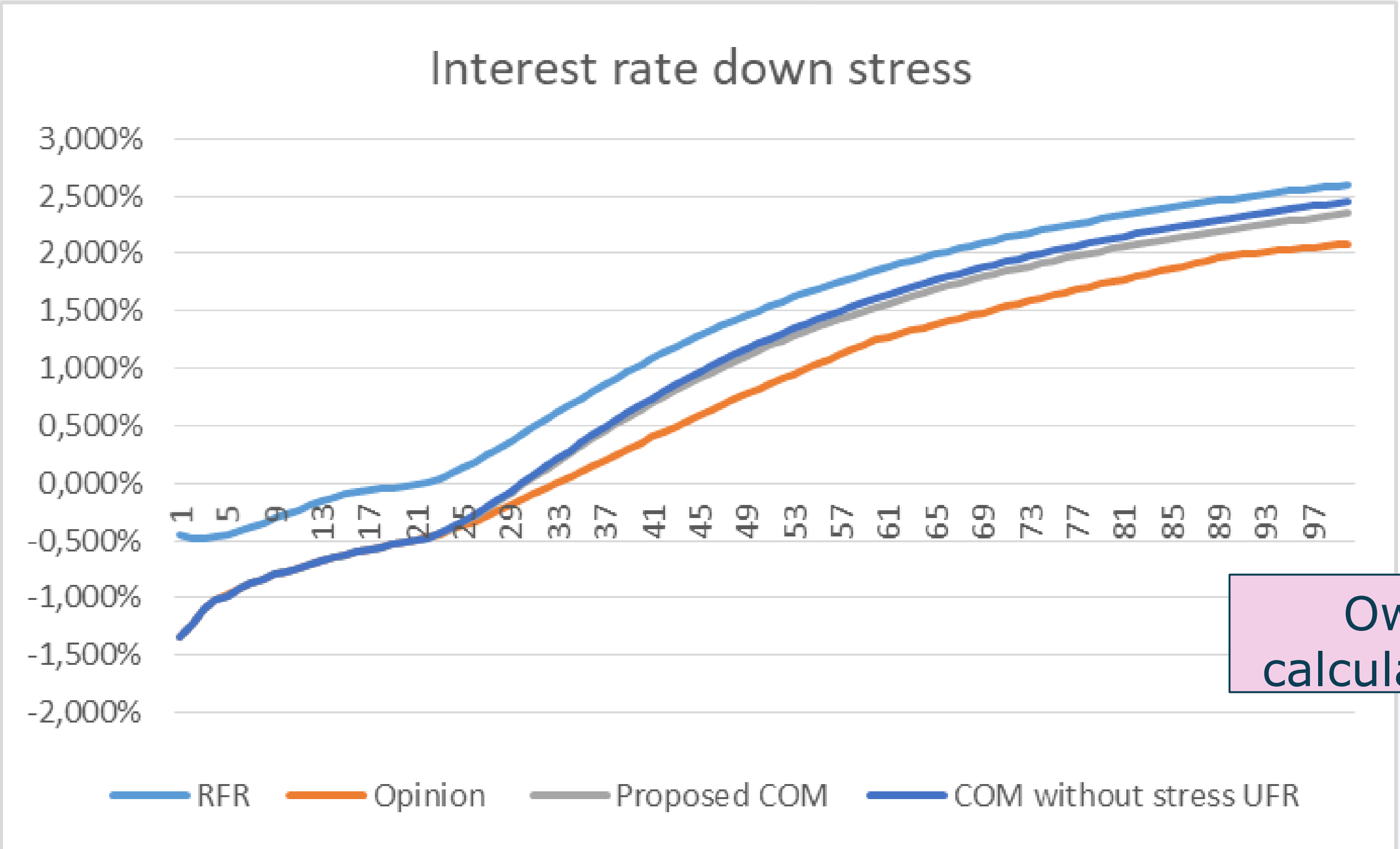
- reflecting EIOPA’s advice on the calculation of the capital requirement for interest rate risk with the standard formula, **with the exception** of an allowance for extrapolation for long-term interest rates.
- for each currency, the stressed risk-free interest rates for maturities up to the starting point of the baseline extrapolation will be derived on the basis of the approach and parametrization proposed by EIOPA in its Opinion.
- The remaining rates could be extrapolated in the same manner as the risk-free rates of the baseline, **however,** towards a stressed UFR.

The Commission will consider phasing in these changes over a period of five years after the adoption of the amendments as proposed by EIOPA in its Opinion.

Source: https://ec.europa.eu/finance/docs/law/210922-communication-solvency-2_en.pdf

Interest rate risk - considerations

Example: Based on RFR from 30 June 2020



Own calculation!

UFR-Stress: a reduction of the UFR by 15 bp considered

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Risk management – Article 44 amended

Several amendments to consider risk resulting from the use of the VA and MA

- Where undertakings apply the VA, their **liquidity plans** shall take into account the use of the VA and assess whether liquidity constraints may arise which are not consistent with the use of the VA.
- Where the **VA** is applied, the written policy on risk management referred to in Article 41(3) shall take account of the VA;

As regards ALM, undertakings shall regularly assess

- The sensitivity of their technical provisions and eligible own funds to the assumptions underlying the calculation of the **matching adjustment**, including the calculation of the fundamental spread;
- Where the VA is applied the sensitivity of their technical provisions and eligible own funds to changes in the economic conditions that would affect the risk corrected spread;

Risk management – Article 45, ORSA

Paragraph 1: Points (d), (e) and (f) added:

The assessment shall include at least

(d) consideration and analysis of the **macroeconomic situation**, and possible macroeconomic and financial markets' developments, and, upon a reasoned request of the supervisory authority, macroprudential concerns, that may affect the specific risk profile, the approved risk tolerance limits, the business strategy, the underwriting activities or the investment decisions, and the overall solvency needs referred to in point (a) of the undertaking;

(e) consideration and **analysis of the activities** of the undertaking that may affect the macroeconomic and financial markets' developments, and have the potential to turn into sources of systemic risk;

(f) the overall capacity of the undertaking to settle its financial obligations towards policyholders and other counterparties when those obligations fall due, even under stressed conditions.

Climate change – New Article 45a

Article 45a **Climate change scenario analysis**

1. For the purposes of the identification and assessment of risks referred to in Article 45(2), the undertaking concerned shall also assess whether it has **any material exposure to climate change risks**. The undertaking shall demonstrate the materiality of its exposure to climate change risks in the assessment referred to in Article 45(1).
2. Where the undertaking concerned has material exposure to climate change risks, **the undertaking shall specify at least two long-term climate change scenarios**, including the following:
   a) a long-term climate change scenario where the global temperature increase remains below two degrees Celsius;
   b) a long-term climate change scenario where the global temperature increase is equal to or higher than two degrees Celsius.

Sustainability risk – New Article 304a

Article 304a **Reviews as regards sustainability risk**

Contains two mandates to EIOPA concerning sustainability risks.

EIOPA is mandated

- to explore by 2023 (EIOPA shall submit a report on its findings to the Commission by **28 June 2023**) a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives and
- to review regularly (at least every three years) the scope and the calibration of parameters of the standard formula pertaining to natural catastrophe risk.

The first review shall be completed three years after entering into force of the Directive.

Macroprudential tools – new Articles 144a, b, c

Article 144a

Liquidity risk management

EIOPA shall develop draft **regulatory technical standards (RTS)** to further specify the content and the frequency of update of the liquidity risk management plan and shall submit these within 12 months after entry into force to the Commission.

Article 144b

Supervisory powers to remedy liquidity vulnerabilities in exceptional circumstances

In order to ensure consistent application of this Article, **EIOPA shall, after consulting the ESRB, develop guidelines to:**

a) provide further guidance on measures to address deficiencies in liquidity risk management and on the form, activation and calibration of powers that supervisory authorities may exercise to reinforce the liquidity position of undertakings when liquidity risks are identified and are not adequately remedied by these undertakings;
b) specify the existence of exceptional circumstances that may justify the temporary suspension of redemption rights;
c) specify the conditions for ensuring the consistent application of the temporary suspension of redemption rights across the Union and the aspects to consider for equally and adequately protecting policyholders in all home and host jurisdictions.

Article 144c

Supervisory measures to preserve the financial position of undertakings during exceptional market-wide shocks

. EIOPA shall, after consulting the ESRB, develop **implementing technical standards (ITS)** to specify the existence of exceptional sector-wide shocks.
EIOPA shall submit those draft ITS to the Commission within 12 months after entry into force. Power is conferred on the Commission to adopt those ITS.

Thank you very much for your attention!

Solvency II

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