SOLVENCY II: AN IMPORTANT STEP TOWARDS AN AMENDED FRAMEWORK

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The Solvency II review process seems to be on the home straight. EIOPA had provided the requested technical advice to the EU-Commission on 17 December 2020 together with extensive background and impact analysis. This analysis was substantiated by two impact assessments conducted by EIOPA with reference date 31 December 2019 (Holistic impact assessment - HIA) and 30 June 2020 (Complementary information request – CIR).

Widely following this advice, the Commission has proposed amendments of the Solvency II-Directive, published on 22 September 2021. The proposals are accompanied by an assessment of the expected impact on the capital position of undertakings. For this the Commission adapted EIOPA's impact assessment by their proposals. A gradual phasing-in is planned for two changes which can have significant impact on undertakings solvency. Thus the estimated short-term capital relief of 90 billion euro at entry into force of the amended framework will decrease considerably until the end of a transition period in 2032.

PROPOSED AMENDMENT OF THE FRAMEWORK

The proposed amendment leaves relevant questions open which hinder an analysis:

a) A reliable assessment of the resulting change of the Solvency II-framework is not possible. Specifications of relevant methods and parameters shall be laid down in upcoming delegated acts or implementing technical standards. Without additional guidance in the Directive, this leaves room for a future transformation and hinders the assessment of the current proposal.

b) A robust and reliable impact assessment is missing. It is yet unclear on which basis the short-term capital relief of 90 billion Euro has been determined. The impact resulting from the proposed changes will significantly depend on the underlying interest rate environment and on the final specification of the parameters and methods. This overall sum does not reveal the different exposures of countries or lines of business.
A meaningful interpretation is not possible.

The political priorities of the EU like the European Green Deal or the Capital Markets Union require high investments. Commission's proposed amendments aim at strengthening the role of insurers as long-term investors, by removing regulatory obstacles. As some aspects of current regulation are assumed to be overly prudent this should be achieved without unduly lowering policyholder protection.

VALUATION OF LONG-TERM BUSINESS

Valuation of liabilities stemming from long-term contracts is a crucial issue in the Solvency II-review. The risk-free interest rate (RFR) term structure is the decisive element for this purpose. The proposals directly affect the determination of the relevant RFR and the volatility adjustment. Considerations concerning interest rate stress and the risk margin are published in an additional communication paper (COM(2021) 580 final). EIOPA's impact assessment showed that changes of the following four elements will have a significant impact on the capital surplus of undertakings.

EXTRAPOLATION

Commission proposes to replace the current extrapolation method by an alternative methodology in line with EIOPA's advice. In a low interest rate environment this will require more capital than the current Smith-Wilson method. Market changes can lead to a higher volatility. EIOPA's impact assessment proved this drawback. The drastic deterioration of the RFR in the first half of 2020 resulted in a loss in capital surplus. To mitigate such effects EIOPA proposed a '*mechanism*', which should allow a gradual phasing-in triggered by the interest rate at the starting point of the extrapolation. The '*mechanism*' would apply if this rate would be lower than that observed end of 2019.

The main reason for this methodological sensitivity is the waiving of a reliable convergence process, which currently stabilises the RFR by requiring a convergence towards the UFR in a fixed period and thus prevents a carrying forward of short- or medium-term financial turmoil to the entire RFR.

The Commission's proposal of an unconditional transition period until 2032 for the implementation of the new methodology shall avoid disruptions during this period. But this does not remedy the identified

fundamental weakness of this methodology which will contribute to a significantly increased volatility.

VOLATILITY ADJUSTMENT (VA)

Commission's proposal is a simplified formula for the calculation of the VA. The risk-corrected spread is still determined on the basis of a currency-specific reference portfolio. A credit spread sensitivity ratio (CSSR) is introduced to reflect undertaking-specific conditions. The VA shall then amount to 85% of this product. The specification of the CSSR and of details for the calculation of the spread shall be specified in delegated acts. The VA can be increased by a macro-economic VA as proposed by EIOPA. It remains unclear how far EIOPA's deep analysis of the VA will be considered in the upcoming regulation. For instance, the illiquidity of liabilities included via an application ratio in EIOPA's advice, is no longer addressed by the Commission.

INTEREST RATE RISK (FOR THE STANDARD FORMULA)

The risk of changes of the RFR shall be reflected on the basis of EIOPA's advice. But the stressed risk-free interest rates shall be derived only up to the starting point of the extrapolation. The resulting stressed curve should then be extrapolated. A stress of 15 bp of the ultimate forward rate will be considered. The AAE had advocated such a proceeding (first stress – than extrapolate) which is more in line with the one-year time horizon for the calculation of the solvency capital requirement.

RISK MARGIN

An adaptation of EIOPA's proposed lambda approach is considered. The lambda parameter had been introduced by EIOPA to attenuate the contribution of projected future capital requirements. A floor should limit the possible reduction. Commission considers to remove this floor parameter and in addition to reduce the cost of capital rate from currently 6% to 5%.

NEXT STEPS

The proposed amendment of the Directive will now be scrutinised by EU-Parliament and Council. The expected negotiations can lead to further adaptations. As the work of actuaries will be affected considerably by the proposed changes, the AAE will monitor developments and provide professional analysis.

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