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Feedback on Commission's proposals on: Insurance & reinsurance firms – review of prudential rules (Solvency II Directive)

General remarks
We acknowledge the huge efforts undertaken by the EIOPA and by the Commission to achieve the now published results.

The AAE assesses Solvency II as well-functioning risk-based framework which is suitable to ensure policyholder protection and financial stability in Europe. Nevertheless, the experience of 5 years of application and especially the low interest rate environment, the COVID-19 pandemic and the progressing climate change revealed the need to reassess the current framework.

The content of the published documents proves the intention to improve the current framework in this regard. To assess the outcome, it is necessary to consider the main goals of this review process[1] and how far these objectives are achieved:

1) *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*
2) *removing regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection*

Another objective concerns proportionality in the application of the Solvency II framework. This should be enhanced in order to avoid creating excessive administrative or procedural burdens especially for medium or small undertakings.

General comment

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. Every appropriate valuation must avoid artificial volatility. This can contribute to a reduction of systemic risk that might otherwise result from pro-cyclical behaviour of market participants.

The proposals aim at addressing these issues. A comprehensive view and assessment of the resulting change of the Solvency II-framework is hindered, as important formulae and specifications of relevant parameters shall become subject to a regulation in upcoming Delegated Acts or Implementing Technical Standards. A principle based guidance for most relevant parameters is still missing. The wide-ranging new additional powers of the EU-Commission leave much room for a future transformation of the current proposal. This impairs the assessment of

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[1]Source: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/capital-markets-union-2020-action-plan_en

the resulting amendments and means increased uncertainty for the future application of Solvency II. Taking into account the possible considerable impact of the proposed changes on the Solvency position of undertakings, crucial issues should be treated holistically. This means, in a simultaneous consideration of the possible amendments across the different components of the legal framework.

Extrapolation of the risk-free interest rate term structure (RFR)
We note the conflicting objectives and opinions regarding the choice of extrapolation methodology for the RFR but on balance do not support the proposed change of methodology for the extrapolation of the RFR. To effectively manage the interest rate risk, insurers are backing their liabilities with fixed-income instruments. Hence, we appreciate the clarification concerning the role of fixed-income instruments in the determination of the starting point for the extrapolation.

Liquid markets identified for swaps beyond this starting point cannot be used for long-term insurance contracts without inducing new risks to the balance sheet. The proposed modification of the starting value of the extrapolation (the last liquid forward rate- LLFR) and the waiving of convergence requirements is a significant flaw of the methodology.

During the COVID-19 crisis we experienced that it is not possible to effectively mitigate short-term market turmoil on insurers' solvency (which is one of the main goals in Commission's action plan). The decline of interest rates between end of December 2019 and June 2020 allowed a comparison in stressed situations of the effects resulting from the use of the proposed methodology to those resulting from that currently used. It resulted in a significantly higher decline of insurers' capital position. Owing to the methodology short-term market distortions have an effect in the entire risk-free rate term structure which leads to an increased volatility of the results. The attempt made by EIOPA and the Commission, to remedy this effect by introducing phasing-in periods, is an additional evidence for this weakness of the methodology.

Starting point for the extrapolation
We appreciate the clarification concerning the role of fixed-income instruments in the determination of the starting point for the extrapolation. However, the threshold used for this purpose based on the percentage of outstanding bonds should be clearly defined or principles provided for its calibration.

Volatility adjustment (VA)
We welcome the proposal to increase the percentage of the General Application Ratio to 85% and the introduction of a macro VA. To reliably assess the overall effects resulting from the proposed change of Article 77d, it is indispensable to know the formula for the calculation of the risk-corrected spread and of the newly introduced credit-spread sensitivity ratio. According to the proposal, details concerning these factors shall be laid down in delegated acts.

The formula for the calculation of the risk-corrected spread should consider the intended functioning of the VA which is the mitigation of short-term volatility and the prevention of pro-cyclical behaviour. In line with this, we do not support an overreliance of spot spreads in the risk correction, expecting it to reduce the counter-cyclical effects of VA.

Complexity: Especially the requirements relating to undertaking-specific elements can lead to considerable burden for undertakings.

Additional requirements to provide liquidity planning before applying the VA seems not to be plausible nor causal for improving the management of related risks.

The risk-corrected spread is still determined on the basis of a currency-specific reference portfolio. This will not remedy the concerns relating to over- or undershooting discussed in EIOPA's opinion.

Interest rate down stress
Although this stress is to be treated in the Delegated Regulation we support some of Commission's considerations laid down in its paper *COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recovery, Brussels, 22.9.2021 COM(2021) 580 final.* We strongly recommend the idea to first stress then extrapolate, which seems to suit best to the one-year time horizon for the calculation of the SCR. Taking into account the existing methodology developed for the calculation of the UFR, a change of 15 bps is the maximum change possible within one year. A higher stress should not be considered.

We do not support the introduction of the absolute floor of -1.25% which was proposed by EIOPA because as we find it, there is always a risk for interest rates to decline but this risk is and also should be calibrated to be considerably lower when rates a low.

Finally, we support the introduction of a phasing in period on any change that will be introduced on interest rate risk calibration. We find that there might be an impact on both the capital requirements but also on insurers' appetite to use interest rate derivatives to lower interest rate risk which can also trigger a wider market impact.

Long-term equity investment (to be considered in delegated acts)
We notice the intention to improve the long-term financing of the economy (as part of the Solvency II review) as mentioned in the CMU action plan.

In this regard we strongly support EC's intention to make LTEI provisions more flexible. The eligibility criteria should reflect ALM practices in long-term equity investments. We would like to remind that the asset class LTEI should come with sound operational constraints, otherwise insurers may be deterred by mere operational considerations.

Liquidity tests rather than more artificial measures (10-year duration and liquidity buffer) should be considered. Both criteria are impaired by possible cliff effects and liquidity buffer for non-life is overly cautious since it does not account for the payment pattern of cash-flows included in the best estimate.

Liquidity test should ensure that no forced sales of LTEI occur even in case of stressed liquidity events.

Concerning participations, we understand the concern that holding of affiliated companies would artificially increase duration on all the equity portfolio. However participations outside the perimeter of the group are instrumental in the long term equity strategy and should be accounted for.

Interest rate correlation

The current calibration of correlation matrices in the Market SCR module differing for negative and positive interest rate shock has, in the past created cliff effects in risk measures. Those two matrices have been designed on UK rates with data up to 2010. More recent data based on euro currency should be considered to reassess this approach.

Reporting requirements in SFCR

The objective of the SFCR must be to give customers a fair and understandable picture of the company's current financial position. Information for the specialised public should be straightforward, easy to understand, and appropriate to the addressee. It should only include the presentation of the base situation, with no additional complex scenarios.

This should be considered in particular if phasing-in processes used or in the context of transition periods (if either transitional measures pursuant article 308c, 308d are used, or in connection to a changed extrapolation methodology).

Proportionality, synergies with other reporting frameworks and consistency with the ongoing ITS review are desirable properties to reduce the implementation costs.

Impact assessment

The extensive impact assessment provided in the four documents is not sufficient and lacks reliability. Based on EIOPA’s assessment the effects resulting from Commission’s preferred options are assessed. This proceeding is questionable regarding the published interpretation and concerning the usability.

1) A meaningful interpretation is compromised, as only overall sums and average values are published. Legal, fiscal, business and other possible constraints have to be considered. These should be reflected in the final legislation.
2) Granularity is not sufficient to allow a meaningful interpretation of the effects for different countries or lines of business. Legal, fiscal, business and other possible constraints have to be considered.
3) The published capital relief of 30 bln (as of 2032) depends significantly on the assumed interest rate environment and on the final specification of the proposed amendments. Crucial formulae and parameters shall be laid down in upcoming delegated acts. It is unclear which assumptions have been used in the impact assessment.
4) The holistic approach chosen by EIOPA does not allow an assessment of the effects resulting from the different proposals. The change of the risk margin effects potentially all undertakings and lowers their capital needs. Undertakings offering long-term business will need a higher capital caused by changes of the extrapolation methodology and the volatility adjustment. This outweighs the positive effect resulting from a lower risk margin and results in a higher capital need. An impact assessment is needed which allows the analysis of these effects.

To sum up, an up-to-date and more granular impact assessment based on documented assumptions is necessary. In addition, empowerments for regulations in upcoming delegated acts should be accompanied by more explicit specifications in the Directive to ensure the expected outcome.
Insurers will have to consider their risk exposure appropriately but there will not be a one-size-fits-all modelling in Pillar 1.

Climate change risk

We underline the requirement “Same risk - same capital”. Besides the role of investors in the capital market the insurance industry has to focus on policyholder protection. If so-called ‘green supporting’ or ‘brown penalising’ factors were introduced in Solvency II capital requirements, they should be science-based and reflect the quality of investments and the inherent risks (while acknowledging that the integration of emerging risks cannot rely solely on historical statistics but needs to factor in forward-looking considerations).

We support the already proposed initiatives concerning the ORSA that contribute to an appropriate integration of climate risk in the Solvency II framework.

Including macroprudential elements

Any extension of the Solvency II Directive should be compatible with the capital requirements of a 1-in-200 year event. Further requirements should not go beyond this level. The microprudential measures of Solvency II can already mitigate the macroprudential risks considerably (as confirmed by EIOPA in its publication from 2018: Solvency II tools with macroprudential impact) In addition, the ORSA ensures that all types of risks are taken into account and is not limited to solvency or microprudential risks. Hence, we currently assess the additional reporting and planning requirements to be going too far in increasing the bureaucracy rather than improving risk management of companies or mitigating effectively macroprudential risks.

Due to the completely different business model of insurers the macro-prudential banking rules cannot be copied to insurance. As an example, the insurance sector’s liquidity risk that has been heavily under discussion was found mostly really low in the 2021 insurance stress test results that were published on December 2021 by EIOPA. Also some new powers for supervisors on group supervision might be needed but we don’t believe that these should be as extensive as suggested. Therefore, new articles 213 (3b) and (3c) should be rather deleted.
However, a Europe-wide harmonisation of supervisory practice is seen to be beneficial in this context.

Recovery and Resolution

of systemic risk in the insurance sector. It notes that insurers are typically seen as less systemically risky than, say, banks and that the most appropriate macroprudential tools to use for this purpose in insurance differ from those applicable for banks, as seems to be recognised in the EU Commission’s September 2021 proposals.

The idea of harmonising recovery and resolution arrangements and hence harmonising how failing insurers might be handled in different European jurisdictions seems intuitively sensible in the context of expected longer-term growth in cross-border business. It will be important to ensure that the eventual regulatory texts achieve a proportionate balance between promoting such harmonisation versus the extra burdens such regulation may place on the insurance industry, bearing in mind the comparative rarity of insurance company failures in Europe.

The AAE stands willing to assist policymakers with actuarial insight in this area should this be desired. It notes the presence already of some actuaries in policymaker forums at which such topics are currently under discussion.

Proportionality

Proportionality plays an important role in the proposal. We broadly agree with the proposed introduction of low risk profile undertakings and the relief granted for this group of undertakings. A threshold based on size for the exclusion of undertakings from the scope of Solvency II, might deserve closer attention as size is not the only indicator for risk and the other criteria can only roughly reflect the risk profile.

The introduction of new requirements related to macroprudential issues, sustainability or recovery and resolution should consider proportionality accordingly.