ACTUARIAL ASSOCIATION OF EUROPE

Item 11.1: Solvency II

Insurance Committee

Rome

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7 October 2022

Agenda

1) Process and timeline
2) Proposed amendments by Council and ECON
3) Others

Next procedural steps

European Council

European Parliament

Trilogue parties

European Commission

Adaptations of a Directive have to be approved by the trilogue parties.

Transposition in national law in all countries within 18 months after approval.

European Commission:	Proposal published December 2021
EU-Council:	General compromise paper published June 2022
European Parliament:	Approval of amendments expected in December 2022

Entering into force of amended Directive in **2025 at the earliest**!

Delegated Regulation, Implementing and Regulatory technical standards or Guidelines are subordinated. Adaptations depending on outcome of the Directive.

Review: Preparation of trilogue parties

<u>Commission (22 September 2021)</u>

a) Proposals amending the Solvency II-Directive

b) Proposal to establish a new framework (Directive) for the recovery and resolution of insurance undertakings

<u>EU-Council</u>: Proposal for amendments to the SII-Directive (Compromise paper) 2 June 2022

Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision

Only a few changes compared to Commission's proposals

<u>Parliament</u> (ECON Committee): Draft report of the rapporteur with proposed amendments to

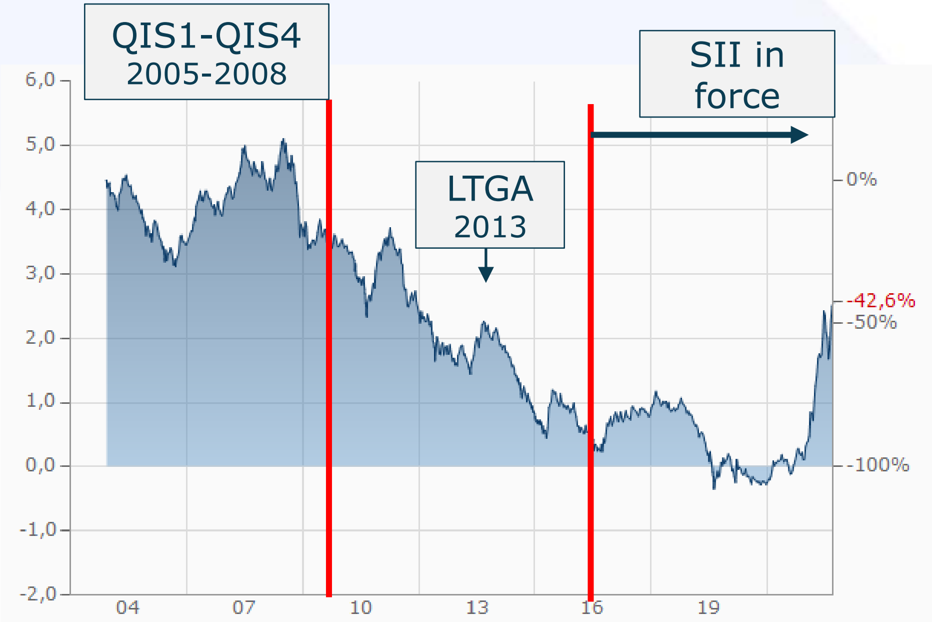
a) Commission's proposal to amend the SII Directive 6 June 2022 → 206 amendments

(August 2022: 599 additional amendments form ECON)

b) Commission's proposal to establish a new Insurance recovery and resolution directive 2 June 2022 → 37 amendments

(August 2022: 158 additional amendments from ECON)

Repercussion of changed interest environment?



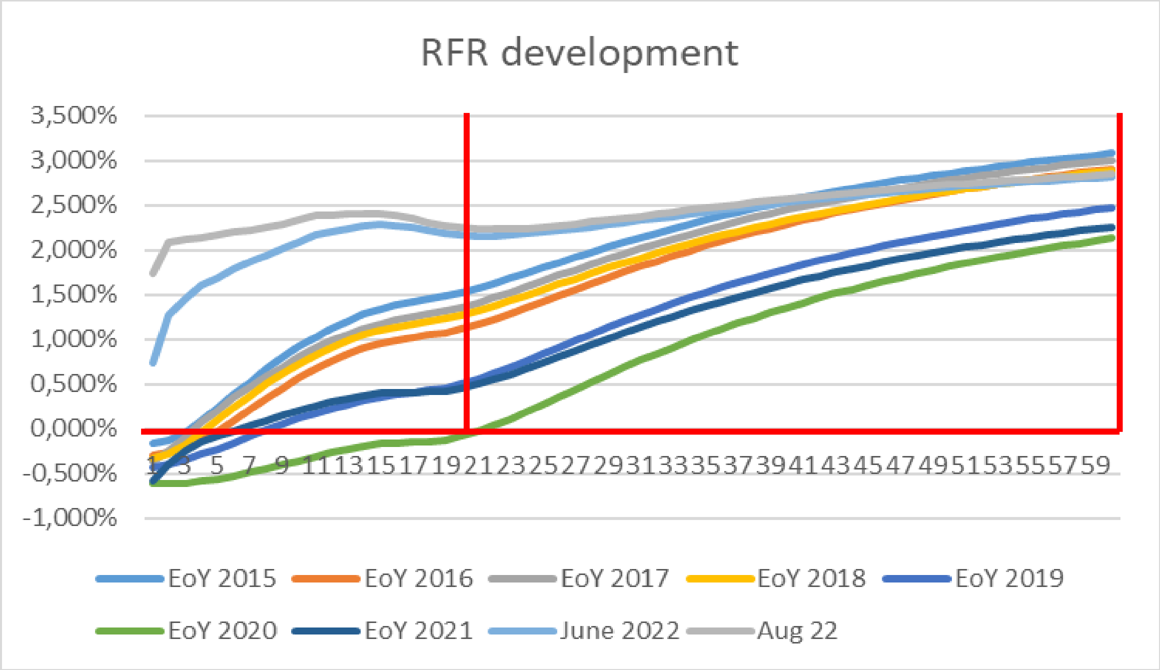
Review-phase dominated by low interest rates.
How to assess recent increase?

26 September 2022:
10 year CMS Swap rate

https://www.finanzen.net/zinsen/cms-swap-satz-eur

Interest level impacts on RFR and SCR

End of low interest rate environment? Impact on current review process?	Ultimate forward rate



Year	UFR
2015	4.20%
2016	4.20%
2017	4.20%
2018	4.05%
2019	3.90%
2020	3.75%
2021	3.60%
2022	3.45%
2023	3.45%

SII review: Assessment of proposed changes

Objective of the review: Keep Solvency II fit for purpose

Possible criteria to assess proposed amendments:

- 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
- The removal of regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection.
  (both above mentioned requirements also included in Commission's Action plan)
  Source: https://ec.europa.eu/finance/docs/law/200924-capital-markets-union-action-plan_en.pdf
- Limiting (avoiding) artificial volatility, preventing procyclical behaviour
- Adequate consideration of new risks
- Maintain the protection level of policyholders

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(Some) Amendments proposed by Council

Sustainability (Article 304a) extended

- EIOPA shall evaluate whether and to what extent undertakings assess their material exposure to risks related to biodiversity loss as part of the assessment referred to in Article 45(1) and prepare a report on its findings
- **ESAs** shall develop guidelines for a stress testing of ESG risks, starting with climate-related factors. They shall explore how ESG-risks can be integrated into stress testing.

Macroprudential risk(Art.144d new: Application of additional macroprudential tools)

EIOPA shall develop two sets of guidelines

a) Criteria for identifying undertakings (groups) which have to

i) carry out the macroprudential analyses (referred to in Art. 45(1)

ii) Incorporate macroprudential considerations as part of prudent person principle (Art. 132)

b) Criteria for defining undertakings (groups) which shall be requested to draw up and maintain a liquidity risk management plan, as well as the content and frequency of update of such plans

... invite the Commission to present the current state of play of envisaged amendments to the delegated Regulation in order to ensure the balance and the consistency of the whole review of the Solvency II framework; (14 June)

Proposed amendments by "ECON"

<u>Basis: </u>Commission's proposed adaptations of the SII-framework

"<u>ECON" encompasses:</u> rapporteurs, shadow rapporteurs, ECON-members

Rough overview of the proposed 805 amendments:

First amendments made by the rapporteur in June differed considerably from Commission's proposal (amendments 1-206)

Most significant:

- Including LTG-related parameters and formula in Level 1,
- Emphasizing the role of politics
- Cancelling Articles 45a (climate risk) and 304a (sustainability)

Further amendments published in August (amongst others):

- Discussion of parameters e.g. risk margin, extrapolation, volatility adjustment
- New recitals proposed, predominantly dealing with sustainability
- Long list of amendments to sustainability risk, climate change risk (≥115) reflecting the political preferences, some referring directly to CSRD

Approval by ECON scheduled for **<u>1 December 2022</u>**

Some examples depicted in following slides (non-exhaustive)

“ECON” proposals: Risk margin (excerpt)

Risk margin 1, 117-118, 263, 264, 551-559,

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

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

EIOPA’s proposal

Not exhaustive!

Commission’s proposal: formula without floor, CoC=5% considered

ECON proposed amendments Include formula in Directive Article 77	
COC	Lambda
4%	0,9 without floor
4,50%	0,975 and floor 0.5
5%	0,995 without floor
6%	
not lower than 5%	
remains risk-based	
calibration set by EC	
CoC set by legislator	
regular review	
consider diversification effects in groups	

New recital 39a For that purpose, the reviews should ensure that the **Cost-of-Capital rate remains risk-based** and is not set at an overly conservative level. In addition, the projection of future capital requirements for that purpose should take into account the **time-dependence of risks** in the aggregation of projected future capital requirements. In particular, projected future capital requirements for later years should have a lesser contribution to the risk margin than projected capital requirements of the same level pertaining to earlier years

"ECON" proposals: Extrapolation (excerpt)

Extrapolation 13, 123-125, 249, 255, 561-571,

EIOPA's proposal (Euro):

- FSP = 20 years, starting point extrapolation, residual volume criterion
- LLFR to consider DLT-Swap markets beyond FSP
- LLFR starting value extrapolation
- Alpha convergence speed proposed 10%

Transition period until 2032, depending on interest rate

Not exhaustive!

Commission's proposal:

based on EIOPA's proposal, but parameters, formulaand threshold to be laid down in delegated regulation → Article 86

Requirement for FSP in Article 77a (residual volume criterion)

Transition mechanism and period independent of interest rate (in 77a)

ECON proposed amendments Include formula in Directive Article 77a			
FSP	Alpha (convergence speed)	convergenc period	convergence tolerance
20 years	5%	40 years	3 bp from UFR
30 years	10%		7 bp from UFR
	18%		
	20%		
Threshold share of bonds	sufficient conv. speed		
	Disclose values 5%		

“ECON” proposals: Volatility adjustment

Volatility adjustment 109, 127-128, 255, 576-596,

EIOPA’s proposal (Euro): $\boldsymbol{VA_{perm}} = \mathbf{85\%} \cdot AR_4 \cdot AR_5 \cdot Scale_c \cdot RC\_S_c$

- AR_4 Correction of mismatch
- AR_5 considering illiquidity of liabilities
- $Scale_c$ Scaling factor
- RC_S_c risk-corrected spread of reference portfolio

\+ country component

Not exhaustive!

Commission‘s proposal (Euro) $\boldsymbol{VA_{cu}} = \mathbf{85\%} \cdot \boldsymbol{CSSR_{cu}} \cdot \boldsymbol{RCS_{cu}}$:

- VA_{cu} VA for currency cu;
- $CSSR_{cu}$ “credit spread sensitivity ratio” of the undertaking
- RCS_{cu} risk-corrected spread of reference portfolio

\+ macro-component

ECO proposed amendments Article 77 d		
Spread	$S = w_{gov} * \max(S_{gov}, 0) + w_{corp} * \max(S_{corp}, 0)$	
VA	VA_{cu} = 85%· $CSSR_{CU}$ · RCS · ALi	Ali reflecting illiquidity
	VA_{cu} = 85%· $CSSR_{CU}$ · RCS_{CU} · BRC $_{(insurer)}$	BRC: basis risk correction to RCS_{cu}
	VA_{cu} = 85%· $CSSR_{CU}$ · ILR_{cu} · RCS_{CU}	ILR_{cu}: illiquidity ratio
Risk-correction	RCgov_eu = max(PD + CoD, 30% *LTAS)	like fundamental spread
	RCcorp_eu = max (PD + CoD, 35% * LTAS)	like fundamental spread
County component	$\omega_{co} = \max(\min((RCS_{co} - 0.6\%) / 0.3\%;1);0)$	country adjustment
	$VA_{Euro,macro} = 85\% \cdot CSSR_{Euro} \cdot ILR_{Euro} \cdot \max(RCS_{co} - 1.3 \cdot RCS_{Euro};0) * \omega_{co}$	ILR_{Euro}: illiquidity ratio
	$VA_{Euro,macro} = 85\% \cdot CSSR_{Euro} \cdot \max(RCS_{co} - 1.3 \cdot RCS_{Euro};0) * \omega_{co}$	Commission's proposal

“ECON” proposals: Volatility adjustment

Not exhaustive!

Volatility adjustment
257-261,576-578

36 a) Where the undertaking invests in **debt instruments which have a better credit quality than the debt instruments contained in the representative portfolio** for the calculation of the volatility adjustment, the volatility adjustment may overcompensate the loss of own funds caused by widening bond spreads and may lead to undue volatility in the own funds. With the objective to offset the artificial volatility caused by such overcompensations, in these cases **undertakings should be able to apply for a modification of the volatility adjustment that takes into account information on the undertaking specific investments in debt instruments**.

Art. 77d: 1c. Insurance and reinsurance **undertakings may, subject to prior approval by the supervisory authority, apply an undertaking-specific adjustment to this risk-corrected spread of the currency** referred to in paragraph 3, under the condition that the information that is inherent to the relevant assets of the undertaking and that is reported by the undertaking in line with Article 35, paragraphs 1 to 4 is of sufficient quality to allow a robust and reliable calculation.

Several attempts to overcome weaknesses resulting from the use of a currency-specific reference portfolio:

- Modification of the formula,
- adapting of spread or
- adjustment of risk-corrected spread.

"ECON" proposals: Symmetric adjustment

Symmetric adjustment 130, 270, 630, 631

EIOPA's proposal:
Extent corridor from -17% to +17% with a floor of 22%

Commission's proposal:
Extent corridor from -17% to +17%

Not exhaustive!

Council:
No change of current regulation

ECON:

- Extent corridor from -17% to +17%
- Modify range from -17% to +10% (in relation to equities not covering liabilities from unit-linked life insurance policies)
- the final capital charge should not be lower than the one which would have resulted from the application of an instantaneous decrease equal to **15%** in the value of the equity investment
- …have resulted from the application of an instantaneous decrease equal to **20%** in the value of the equity investment.

“ECON” proposals: Climate risk, Sustainability

Climate risk, Sustainability 22, 291-298, 478-490, 492-537, 619-623, ….

Not exhaustive!

Commission’s proposal:

New Article 45a: Climate change scenario analysis
New Article 304a: Mandates as regards sustainability risks

Council: Consider risk related to biodiversity loss in Article 304a

Proposals can / will result in
- Higher requirements on risk management, ORSA
- Extended disclosure requirements
- Transition plans: burdensome for SMEs (high reputational risk)
- Calibration of market risk: consideration of climate related risks
- Affect matching and volatility adjustment: excluding assets in fossil sector,..

ECON proposed amendments Articles 45a, 304a		
Aricles 45a, 304a	Scenarios	Transition plan (new art. 44a
delete new articles	at least three scenarios	disclose plan in SFCR
	modelling a period of at least 30 years	NSA to verify alignment with plan
	a long-term scenario, increase more than 2 degrees	approval by supervisor
	performing backward analysis on previous scenarios	disclose climate ORSA results
	orderly transition scenario reaching net-zero in 2050	
	"disorderly" scenario, later and sharper reductions	
	"hot house world"-scenario, increase higher 3 degrees	
	increase significantly higher than two degrees	

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Low-risk profile undertakings (LRU)

LRU were introduced by Articles 29a-29d in Commission's proposal

Article 77: , the following paragraphs 6 and 7 are added:

7. Notwithstanding paragraph 6, undertakings that are classified as low-risk profile undertakings may **use a prudent deterministic valuation** of the best estimate for life obligations with options and guarantees that are not deemed material.';

Article 86:

2a. In order to ensure uniform conditions of application of Article 77(7), EIOPA shall develop draft ITSs specifying the set of scenarios to be used for the prudent deterministic valuation of the best estimate for life obligations referred to in that paragraph.

EIOPA shall submit those draft ITSs to the Commission by [OP please insert date = 12 months after entry into force].

Power is conferred on the Commission to adopt those ITSs in accordance with Article 15 of Regulation (EU) No 1094/2010.

Low-risk profile undertakings (LRU)

EIOPA: Workshop with stakeholders on 15 September 2022 to discuss methodological options for scenarios generation with stakeholders.

EIOPA’s timeline

→ Step 1: Selection of few methodological options to produce the PHRSS Q4/2022

→ Step 2:First impact assessment planned for Q1/2023

→ Step 3:Second impact assessment planned for Q3/2023

→ Step 4: Finalization of the methodology Q3/2023

→ Step 5: Finalization of the PHRSS framework Q1/2024

Prudent harmonised reduced set of scenarios

EIOPA's questions concerning PHRSS

Q1. Would some LRPU undertakings voluntary participate ?
Q2. Could full ESG TP calculations be adapted to take into account only the PHRSS subset of risk factors ?
Q3. Could the figures be provided at the LOB granularity ?
Q4. What kind of risk factors should be included?
Q5. What currencies should be included?
Q6. What time step should be used?
Q7. What time horizon should be considered?
Q8. What is the preferred expected outcome for the scenarios?
Q9. Should EIOPA publish tables on a regular basis, or a tool?
Q10. Should the calibration be market consistent or should it be based on historical volatilities?
Q11. Could a real-world model based on SII standard formula shocks (see appendix) be used?
Q12. What is the view of stakeholders regarding the feasibility of the 2 step approach ?
Q13. What is the view of the stakeholders regarding the methodologies presented for the first step (generation of the raw scenarios) ?
Q14. What is the view of the stakeholders regarding the methodologies presented for the second step (scenarios adjustments) ?
Q15. Do stakeholders have other comments regarding the methodology presented ?

→ see annex 11.2: Prudent Harmonized Reduced Set of Scenarios (PHRSS) Methodological options for scenarios generation

Solvency II

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