ACTUARIAL ASSOCIATION OF EUROPE

Solvency II-review: Preparatory work of the trilogue parties

Webinar

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23 November 2022

Solvency II 2020 review - agenda

1) Background and stock-taking
2) Review process and proposed amendment
    a) Proportionality: lower administrative burden
    b) Macroprudential issues
    c) LTG measures

3) Recovery and resolution

Required reviews – explicitly or implicitly

Solvency II Directive, with deadline

Article 77f: Review of LTG-measures and measures on equity risk

Based on the opinion submitted by EIOPA, the Commission shall submit a report to the European Parliament and to the Council by **1 January 2021**

Article 300: The EUR-amount thresholds **shall be revised every 5 years**, starting 31 December 2015, when the percentage change since the previous revision is at least 5%.

Delegated regulation, with deadline

(150) SCR-Review: This review should make use of the experience gained by insurance undertakings during the years of application of these delegated acts and be **performed before December 2018**.

Solvency II Directive, without deadline

Article 77: The rate used in the determination of the cost of providing that amount of eligible own funds (Cost-of-Capital rate) shall be the same for all insurance and reinsurance undertakings and **shall be reviewed periodically.**

Delegated Regulation, without deadline

(56) The calibration of the interest rate risk at longer maturities should reflect that the ultimate forward rate towards which the risk-free interest rate term structure converges to is stable over time and only changes because of **changes in long-term expectations.**

Requirement and guidance from politics

Consistency with the EU's political priorities. In particular, the insurance sector should play a role

- In financing the **post COVID-19 economic recovery**,
- in completing the **Capital Markets Union** (CMU) and
- in achieving the targets of the **European Green Deal**.

For instance, ***the EU climate targets for 2030 will require €350 billion*** *of additional annual investment just to finance transition in the energy sector. The role of private investment has also become even more prominent given the need for economic recovery following the COVID19 pandemic.*
https://ec.europa.eu/finance/docs/law/210922-communication-solvency-2_en.pdf

Goal of politics: Relief of capital to enable insurers to act as long-term investor

Commission‘s objectives: general and specific

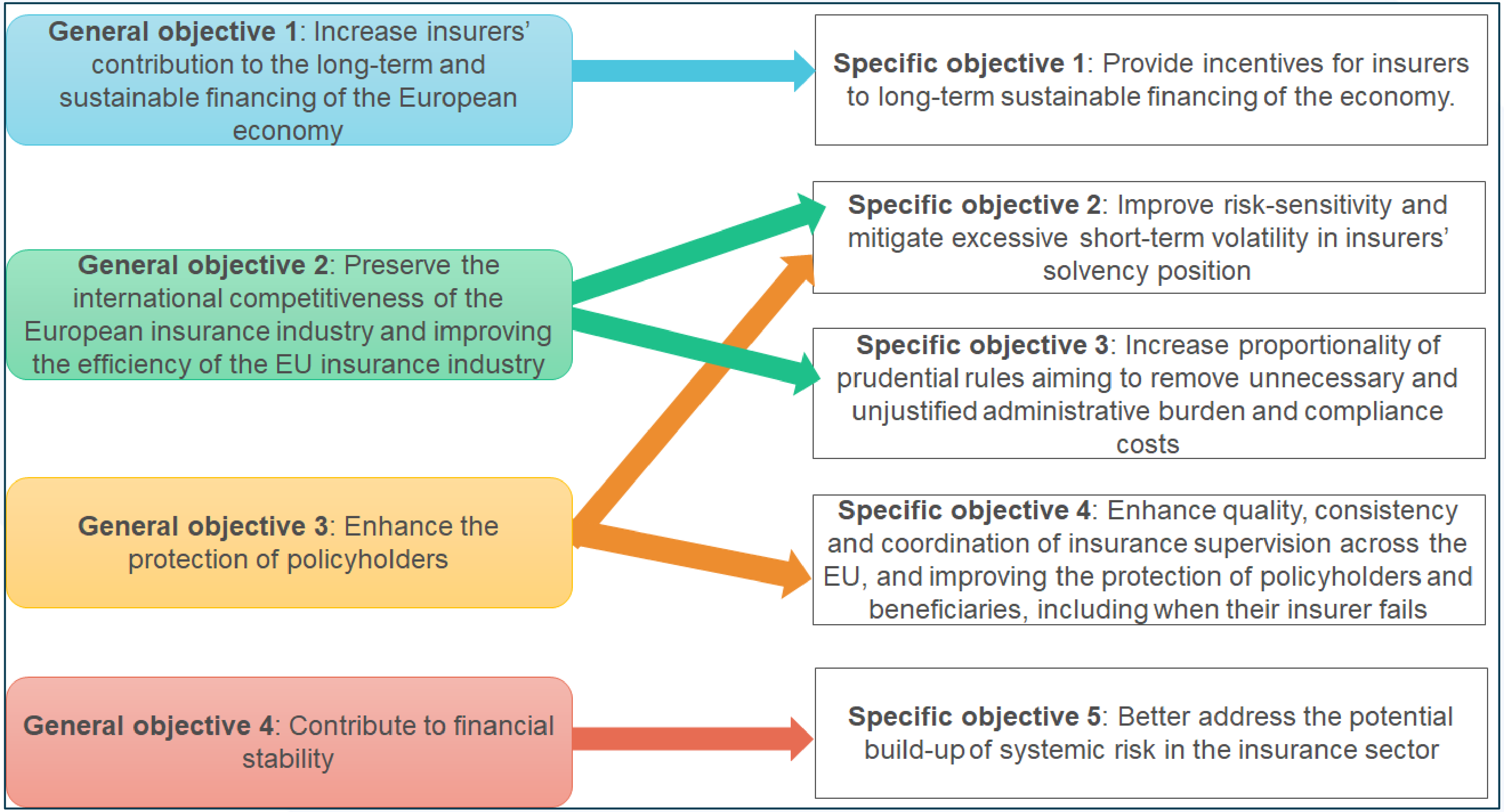

Figure 2: *links between general and specific objectives* Source: *Impact assessment report*

Solvency II review: overall requirements

Required by Directive, Art. 77f: to review e.g.

- long-term guarantees (LTG) measures
- methods, assumptions and standard parameters used in standard formula

Extension of the SII-framework:

- by macroprudential elements
- by ESG-issues (Environmental, social and governance), sustainable finance

Objectives

- Keeping Solvency II fit for purpose
- Consider proportionality adequately
- Remove obstacles for insurers to invest long-term

Evolution not a revolution!

Main Solvency II-principles should remain unchanged

- Solvency II risk-based
  - 99.5% Value at risk of own funds within a one-year horizon
  - Market consistent valuation
  - Going-concern principle
- Principle-based

Possible antagonism? → policyholder protection vs. financing European economy

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Solvency regime encompasses several levels

Structure determined by the Treaty on the Functioning of the European Union (TFEU) and EIOPA Regulation 1094/2010

Review will affect Level 1 and Level 2

Level 1

Directive 2009/138/EG from 25 November 2009, amended by Omnibus II – Directive 2014/51/EU from 16 April 2014

Transposition into national law required

SII-Review 2020 **!**

Level 2

Delegated regulation 2015/35 from 10. October 2014 taking up these empowerments

Applicable without transposition into national law.

mandatory

SCR-Review 2018 ✓

Level 2,5

Implementing technical standards (ITS) and Regulatory Technical Standards (RTS)

Especially reporting issues

Applicable immediately

mandatory

Level 3

Guidelines for further clarification

Issued by EIOPA

Addressing NSAs

„Comply or explain"

Solvency regime and impact on review process

Treaty on the functioning of the European Union (TFEU), relevant for review process

Directive (legislative act) Article 289, TFEU

1. The ordinary legislative procedure shall consist in the joint adoption by the European Parliament and the Council of a regulation, directive or decision on a proposal from the Commission.

Trilogue process required (article 294, TFEU)

Delegated Regulation: (delegated act) empowerment by legislator required (Article 290, TFEU)

*1) A legislative act may delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend **certain non-essential elements** of the legislative act.*

2. Legislative acts shall explicitly lay down the conditions to which the delegation is subject; these conditions may be as follows:

*(a) the European Parliament or the Council may decide to **revoke the delegation**;*

*(b) the delegated act may enter into force only if **no objection has been expressed by the European Parliament or the Council within a period set by the legislative act.***

Legislators not involved in development of delegated acts: but has possibility to object

Interplay of Directive and Delegated Regulation

View of co-legislators

EU-Council suggestions:
(Addendum to the compromise paper, 14 June 2022)

-reckon that given the close links between the SII Directive 2009/138/EC and its DR (EU) 2015/35, amendments to both acts will be needed to reach the objectives of a balanced and consistent review;

- invite the Commission in this regard: to present the current state of play of envisaged amendments to the DR in order to ensure the balance and the consistency of the whole review of the SII framework;

Explanatory statement in the rapporteur's draft report:

Delegated acts are not the appropriate instrument to deal with political issues. The fact that 10 years after the Omnibus II Directive, amongst others introducing LTG measures into Solvency II at the explicit wish of the Parliament, these LTG measures continue to being discussed, implies that Parliament was right in insisting on inclusion at Level 1 and that the Commission proposal to make important changes only via a delegated act, is not the appropriate way forward.

For these reasons, your rapporteur proposes in this draft report amendments to provide more details and political guidance directly into the Directive in relation to:

- *the risk-free interest rate curve, including the extrapolated part;*
- *the Risk Margin;*
- *the Volatility Adjustment;*
- *long-term equity investments*

Next procedural steps

European Council

European Parliament

European Commission

Trilogue parties

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**!

Solvency II Directive and its Delegated Regulation (EU) 2015/35 are closely linked.
Amendments of both are necessary to reach the objectives of the review.
Implementing and Regulatory technical standards or Guidelines are subordinated.
Adaptations might be needed as well.

Review: Preparation of trilogue parties

Commission (22 September 2021)

a) Proposals amending the Solvency II-Directive
b) Proposal to establish a new framework (Directive) for the recovery and resolution of insurance undertakings

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

Only a small number of amendments to Commission's proposals

Parliament: Draft report of the rapporteur with proposed amendments to

a) Commission's proposal to amend the SII Directive, 6 June 2022
   → *205 amendments (August 2022: 600 additional amendments form ECON)*
b) Commission's proposal to establish a new Insurance Recovery and Resolution Directive, 2 June 2022
   → 36 amendments *(August 2022: 159 additional amendments from ECON)*

How could actuaries assess the proposed changes?

Some questions to assess proposed amendments:

- Does amended framework appropriately reflect the long-term nature of the insurance business and mitigate the impact of short-term market turmoil on insurers' solvency?
- Are regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection removed?

  (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
- Does it contribute to limit (avoid) artificial volatility and prevent procyclical behaviour?
- Are new risks adequately considered?
- Is the protection level of policyholders maintained?
- Will the framework still be principle-based?

Artificial volatility can be defined as a volatility of technical provisions, capital or capital requirements that does not reflect changes in the financial position or risk exposure of the (re)insurer, but which is caused by regulatory requirements that do not capture the long-term nature of the business.

(Karel van Hulle 2019, Solvency requirements for EU insurers II, p.210)

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Proportionality – Exclusion, depending on size

Adapt the thresholds for exclusion: (proposed change of Article 4):

Threshold gross written annual premium	**Thresholds for technical provisions**
Currently: **5 Mio. Euro**	Currently: **25 Mio. Euro**
Commissions proposal: **15 Mio. Euro**	Commission's proposal: **50 Mio. Euro**
(*25 Mio. Euro in further proposals*)	(*65 Mio. Euro in further proposals*)

Higher thresholds could waive the mandatory application of SII for **up to 186 insurers**.

But: Undertakings can decide to use Solvency II, nevertheless.

Source: COMMISSION STAFF WORKING DOCUMENT Impact assessment report

Proportionality - Use of exclusion differs

Country	Exclusion fro scope of SII: Which regime is applicable?	Excluded from SII
Austria	Other than Solvency I or Solvency II	49
Belgium	Solvency I rules	3
Bulgaria	Solvency I rules	5
Croatia	Solvency II rules, but with some differences (e.g. exemptions) no undertakings excluded	0
Cyprus	Solvency II rules, but with some differences (e.g. exemptions)	1
Czech Republic	Solvency II rules, no undertakings excluded	0
Denmark	Solvency II rules, but with some differences (e.g. exemptions)	11
Estonia	Solvency II rules, no undertakings excluded	0
Finland	Other than Solvency I or Solvency II	6
France	Solvency I rules	237
Germany	Other than Solvency I or Solvency II	27
Greece	Solvency II rules, but with some differences (e.g. exemptions)	2
Hungary	Solvency I rules	10
Iceland	Other than Solvency I or Solvency II, no undertakings excluded	0
Ireland	Solvency I rules	1
Italy	Other than Solvency I or Solvency II	1
Latvia	Solvency II rules, no undertakings excluded	0
Liechtenstein	Other than Solvency I or Solvency II, no undertakings excluded	0
Lithuania	Solvency II rules, no undertakings excluded	0
Luxembourg	Solvency II rules, no undertakings excluded	0
Malta	no undertakings excluded	0
Netherlands	Solvency II rules, but with some differences (e.g. exemptions)	22
Norway	other than Solvency I or Solvency II, no undertakings excluded	0
Poland	Solvency II rules, but with some differences (e.g. exemptions)	1
Portugal	no undertakings excluded	0
Romania	Solvency I rules	1
Slovak republic	no undertakings excluded	0
Slovenia	Solvency II rules, no undertakings excluded	0
Spain	Solvency II rules, but with some differences (e.g. exemptions)	11
Sweden	other than Solvency I or Solvency II	26

Directive, Article 300: The EUR-amount thresholds shall be revised every 5 years, starting 31 December 2015, when the percentage change since the previous revision is at least 5%

No exclusion is allowed in the 13 countries.

Different regimes legal requirements for excluded undertakings.

<u>To consider:</u>

If any of the thresholds is exceeded for three consecutive years, SII Directive shall apply as from the fourth year (Directive, Article 4 (2)): .

Source: **BACKGROUND DOCUMENT ON THE OPINION ON THE 2020 REVIEW OF SOLVENCY II** Analysis EIOPA-BoS-20/750 17 December 2020:

Proportionality – Low-risk profile undertakings (LRU)

Article 29a **Criteria for identifying low-risk profile undertakings**
Criteria to be met for two consecutive financial years prior to such classification.
Modification proposed by Council in red writing

Life insurance undertakings	Non-life insurance undertakings:
- technical provision (TP) ≤ 1,000,000,000 € - interest rate risk submodule: ≤ 5% of TP	- average combined ratio last three years ‹ 100% - annual GWP ≤ 100,000,000 Euro - sum of GWP in classes 3 (5)-7, 11, 12, 14 and 15 ≤ 30% of non-life business

- investments in non-traditional investments ≤ 20% of local investments (investment in traditional investments › 80% of total investments)
- business does not include reinsurance operations exceeding 50% of annual total GWP income
- business underwritten in other Member States ≤ 5% of annual GWP or ≤ 15,000,000 €

Commission: At least 249 insurers within scope of SII would benefit from such a classification.

Never be classified as LRU: e.g.
(a) undertakings using an approved partial or full internal model to calculate the SCR
(b) parent undertakings of an insurance group, unless group is classified as low-risk profile group.

LRU: Simplified valuation of options and guarantees

Article 77: LRU may use a **prudent deterministic valuation** to calculate the best estimate for life obligations with options and guarantees (if not material).

Article 86: EIOPA shall specify the set of scenarios (prudent harmonized reduced set of scenarios – **PHRSS**) to be used for this prudent deterministic valuation in an ITS (Due date: 12 months after entry into force).

EIOPA has already started its activities in this regard:

Challenge: Generation of such a small set of scenarios (not more than 10) for such a valuation. Methodological options had been discussed in a workshop with stakeholders on 15 September 2015

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

Proportionality measures

Article 29c **Use of proportionality measures by undertakings classified as low-risk profile**

LRU may use all the proportionality measures provided for in

- Article 35(5a)	Information to be provided for supervisory purposes
- Article 41	Governance
- Article 45(1b), (5)	ORSA
- Article 45a(5)	Climate risk
- Article 51(6)	SFCR
- Article 51a(1)	Audit
- Article 77(7) and	Calculation of technical provsions
- Article 144a(4)	Liquidity risk management plan

- and any proportionality measure provided for in delegated acts adopted pursuant to this Directive.

Article 29d **Use of proportionality measures by undertakings not classified as LRU**

Undertakings **can apply for the use** of the proportionality measures, excluded those in blue writing.
Approval by supervisory authority required.

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European System of Financial Supervision (ESFS)

European Systemic Risk Board (ESRB) – macro view

- ECB Council (with insurance and securities alternates where necessary)
- Chairs of EBA, EIOPA & ESMA
- European Commission
- Non-voting: Representative of the national supervisor(s) per Member State + EFC President

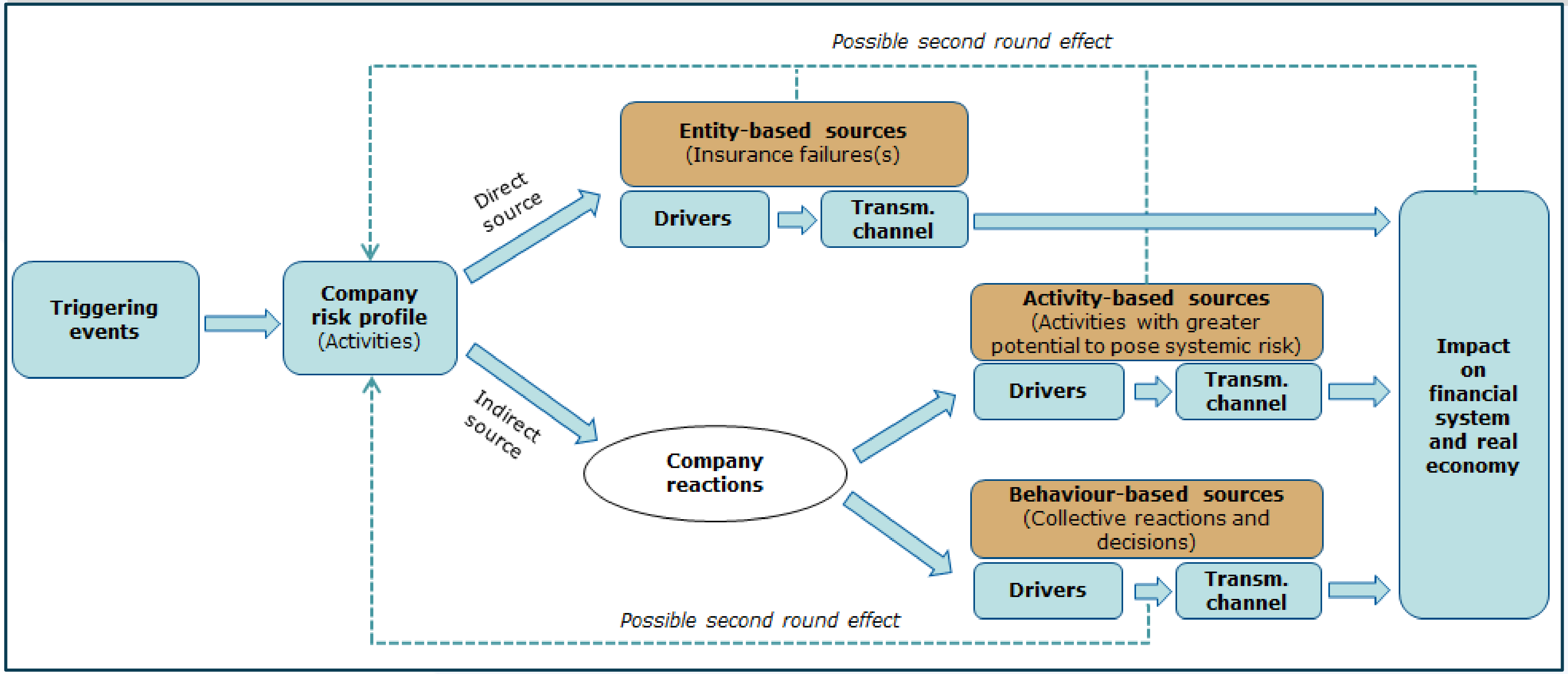
European Supervisory Authorities (ESA) and National Supervision – micro view

European Banking Authority (EBA)	National Banking Supervisors
European Insurance and Occupational Pensions Authority (EIOPA)	National Insurance and Pension Supervisors
European Securities and Markets Authority (ESMA)	National Securities Supervisors

ESFS established 1 January 2011
Omnibus I-Directive 2010/78/EU
24 November 2010

Macroprudential issues: sources of systemic risk

Systemic events in insurance could be generated in two ways:
"**direct" effect**: failure of a systemically relevant insurer or the collective failure of several firms generating a cascade effect. This systemic source is defined as "***entity-based***";
"indirect" effect: - engagement in potentially systemic activities **(*activity-based* sources**),
- widespread common reactions of firms to exogenous shocks (***behaviour-based* source**)



Source: BACKGROUND DOCUMENT ON THE OPINION ON THE 2020 REVIEW OF SOLVENCY II Analysis

Liquidity risk management

Article 144a:
Requires undertakings when requested by supervisory authorities
- to draw up and maintain liquidity risk management plans (LRMP), projecting the incoming and outgoing cash flows in relation to their assets and liabilities to assess the level of potential mismatches in the short and medium term,
- to develop a set of liquidity risk indicators to identify, monitor and address potential liquidity stress
- to submit the LRMP to the supervisor (as part of information required by Art. 35(1)
- LRUs ~~and undertakings using proportionality measures (Article 29d)~~ not obliged to develop LRMP
- LRMP required for undertakings applying the volatility adjustment can be combined

EIOPA shall develop draft RTS, to further specify content and frequency of update of LRMP.

Amendments made to Commission's proposal:
- modifications made by Council directly indicated in dark red in the text
- no need to develop RTS (rapporteur)
- develop RTS and specify also the format of LRMP
- submit LRMP as part of the ORSA (would better fit)

Liquidity risk management

Article 144b:
Supervisory powers to remedy liquidity vulnerabilities in exceptional circumstances

Supervisors shall monitor the liquidity position of undertakings and
- Inform undertakings if material liquidity risk is identified
- Undertaking shall explain how it intends to address this risk

Liquidity risks or deficiencies identified: power to require reinforcement of liquidity position.
Last resort measure: power to **temporarily suspend redemption rights of policyholders**
During this period, ensure that payments to shareholders or subordinated creditors, share buy-back or repay of own funds and payment of bonuses or variable remuneration are suspended as well.

EIOPA shall together with ESRB develop guidelines to provide further guidance.

Amendments made to Commission's proposal by ECON-members:
- suspending of redemption rights not a precondition for the other measures

Liquidity risk management

Article 144c:
Supervisory measures to preserve the financial position of undertakings during exceptional ~~market~~ sector-wide shocks

- During periods of exceptional sector-wide shocks which potentially can threaten the financial position of the undertaking or the stability of the financial system.
- During such periods, undertakings with a particularly vulnerable risk profile shall take at least the following measures: restrict or suspend
  (a) dividend distributions (shareholders and subordinated creditors);
  (b) other payments to shareholders and other subordinated creditors;
  (c) share buy-backs and repayment or redemption of own fund items;
  (d) bonuses or other variable remuneration.

EIOPA shall, after consulting the ESRB, develop draft ITS to specify the existence of exceptional sector-wide shocks.

Amendments made to Commission's proposal made by ECON-members:
- measure shall not be discriminatory when applied to only a subset of undertakings

Additional macro-prudential tools

Proposed by Council

Article 144d:
Application of additional macro-prudential tools
EIOPA shall develop guidelines to ensure consistent application of macroprudential tools on:

(a) Criteria NSAs must consider when defining undertakings/groups which shall be requested to:
- (i) carry out the additional macroprudential analyses referred to in the ORSA;
- (ii) incorporate macroprudential considerations as part of the PPP;

(b) Criteria NSAs must consider when defining undertakings/groups which shall be requested to draw up and maintain a LRMP.

Both shall be commensurate to the risks entailed and consider, in conjunction,

Concerning a) size, nature, complexity, level of interconnectedness with financial markets and cross-border nature of insurance activities and the investments of the undertakings
Concerning b) the composition of the asset and liability portfolios, the nature and variability of insurance obligations and the exposure of assets' expected cash-flows to market fluctuations.

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Long-term guarantee (LTG) measures

LTG-measures introduced by the Omnibus II–Directive.
Goal: Facilitate an appropriate valuation of long-term business. Mandatory review until 2021

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 (TRFR)
308d	Transitional measure on technical provisions (TTP)

* Extrapolation is the only non-optional measure

Different business models must be considered

Annual LTG-Reports on the use of LTG-measures provided by EIOPA (2016 - 2020)
Importance of LTG – measures differs significantly across Europe
VA and the transitional measure on technical provisions are of highest importance

LTG 2020: Number of undertakings using the measures							
Type of undertaking	Total number of undertakings	**VA**	**TTP**	**MA**	**TRFR**	**DBER**	**No measure**
Life	**444**	**236**	**84**	**2**	**2**		**196**
Non-Life	**1.322**	**193**	**10**	**0**	**3**	**1**	**1.127**
Both life and non-life	**387**	**178**	**42**	**12**	**2**	**0**	**203**
Reinsurance	**305**	**24**	**0**	**0**	**1**	**0**	**281**
Total	**2.458**	**631**	**136**	**14**	**8**	**1**	**1.807**
Number of countries		**21**	**11**	**1**	**4**	**1**	

Methods of SCR-calculation

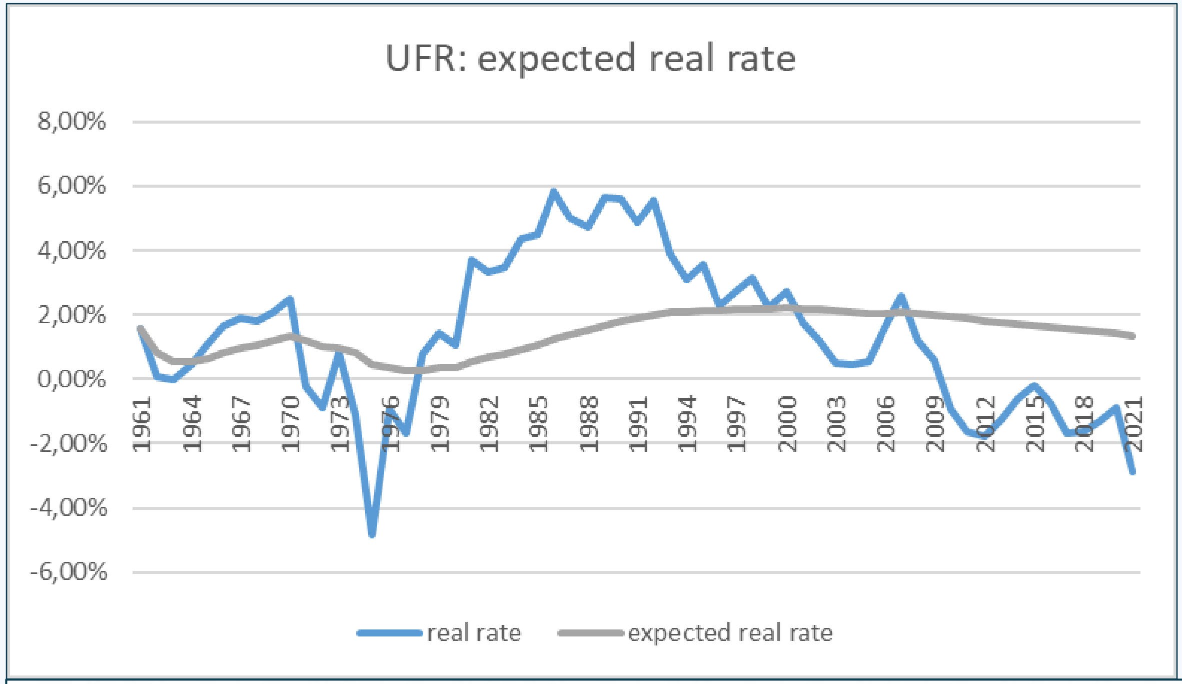
Number of undertakings				
	Standard formula	Partial internal model	full internal model	Total
Life undertakings	353	29	5	387
Non-life undertakings	414	16	14	444
Undertakings pursuing both life and non-life	1.259	39	24	1.322
Reinsurance undertakings	285	7	13	305
Total	**2.311**	**91**	**56**	**2.458**
Groups	**253**	**26**	**3**	**282**

Source: LTG Report 2020

LTG-measures are predominantly related to the standard formula.
Sustainability and macro-prudential issues will affect users of internal models as well.
New: Internal model-users required to report regularly an estimation of the SCR calculated with standard formula (Art. 112)

Changes since S II became effective: UFR, inflation

Ultimate forward rate considerably lower.
Possible impact on extrapolation?

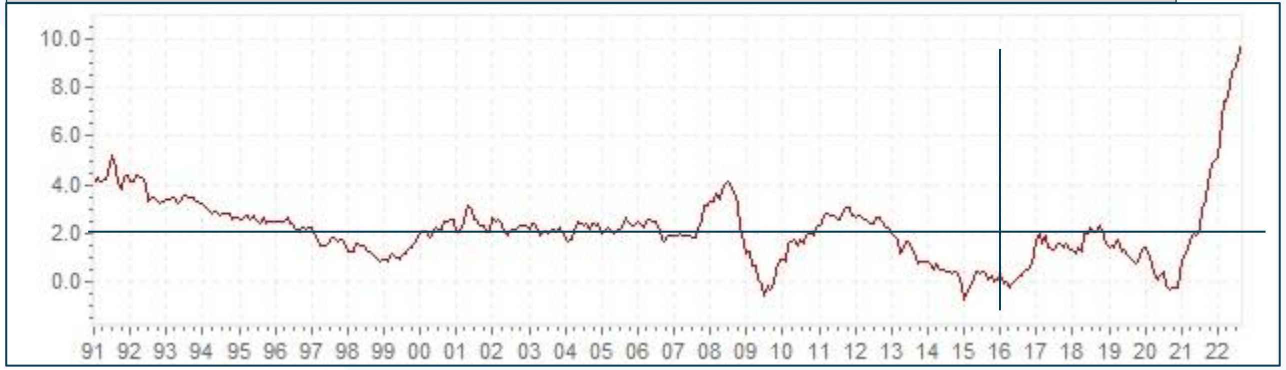


Year	UFR
2015	4.20%
2016	4.20%
2017	4.20%
2018	4.05%
2019	3.90%
2020	3.75%
2021	3.60%
2022	3.45%
2023	3.45%
2024	*3.30%*

2018: Change of methodology to determine expected real rate introduced.

UFR still calculated as expected inflation plus expected real rate.

Expected inflation rate: ECB's target rate 2% unchanged



Sharp increase of inflation in Europe

Historic harmonised inflation Europe – HICP inflation

https://www.inflation.eu/en/inflation-rates/europe/historic-inflation/hicp-inflation-europe.aspx

Changes since SII became effective: level of interest rates

What is the impact of changed interest environment on the review process?

QIS1-QIS4
2005-2008

SII in
force

3 November 2022:
10 year CMS Swap rate

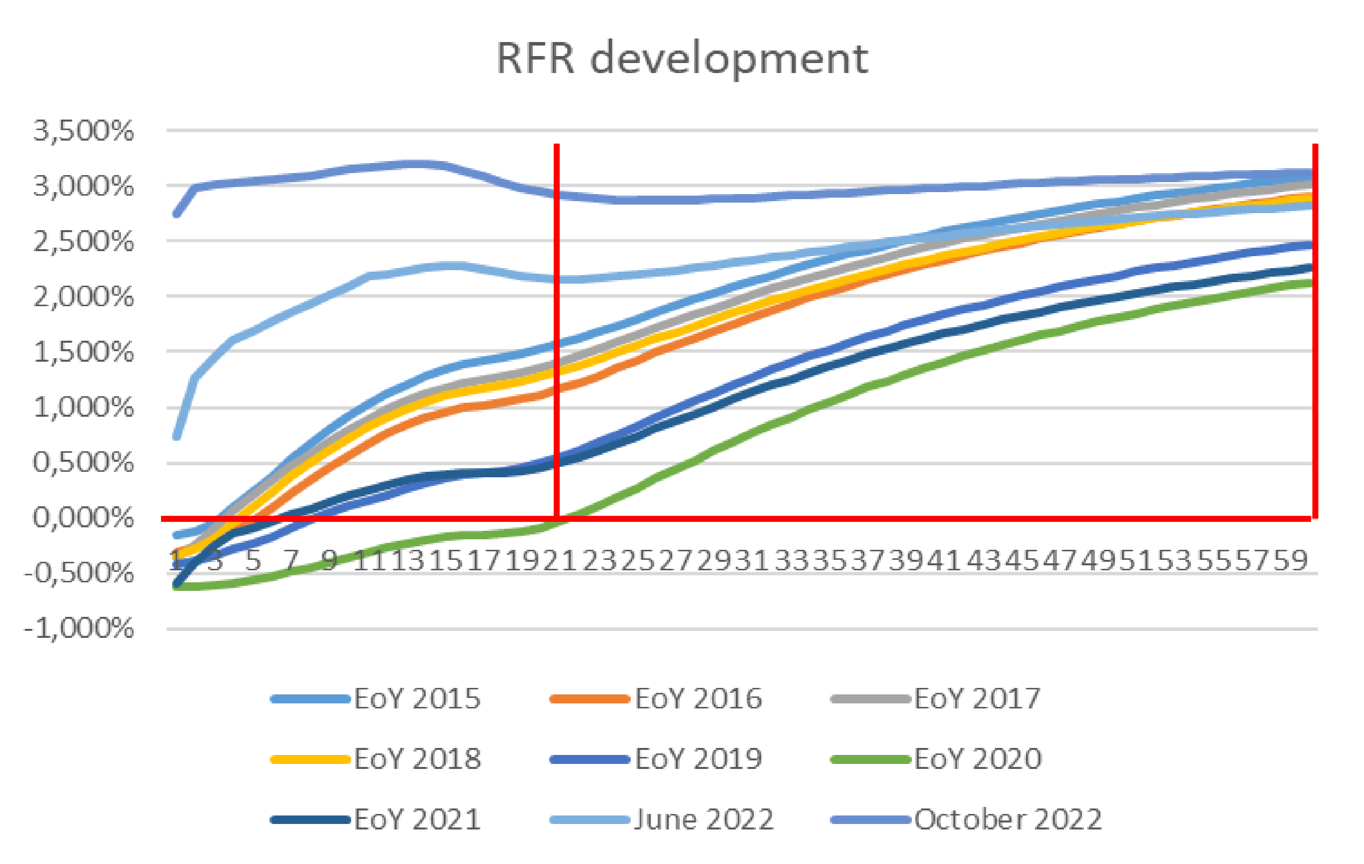
https://www.finanzen.net/zinsen/cms-swap-satz-eur

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

Changes since Solvency II became effective: RFR

Higher interest rate environment affects the review. Impact on insurers' solvency?

Increased interest rates, but inverse term structure in liquid part



Inflationary tendency are observable.

Capital markets are still in a state of flux.

Higher interest rates for short durations, inverse term structure for longer maturities are indicators for insecurities in financial markets.

The different interest rate environments since 2016 allow a differentiated view on the adequateness of the proposed changes.

Risk-free interest rate term structure rate (RFR)

No market price for insurance liabilities → Rules for an adequate valuation required.
T<u>echnical provisions</u>: Best estimate (cash flows discounted by means of RFR) plus risk margin.

RFR shall be derived from financial instruments in deep, liquid and transparent (DLT)-markets (market consistent)
The RFR affects directly

- the calculation of the best estimate technical provision
- the risk margin
- the solvency capital requirement (SCR)

Insurance contract can have very long duration. No DLT-markets existent for such durations.
Prolongation of the RFR is necessary (mark-to-model)

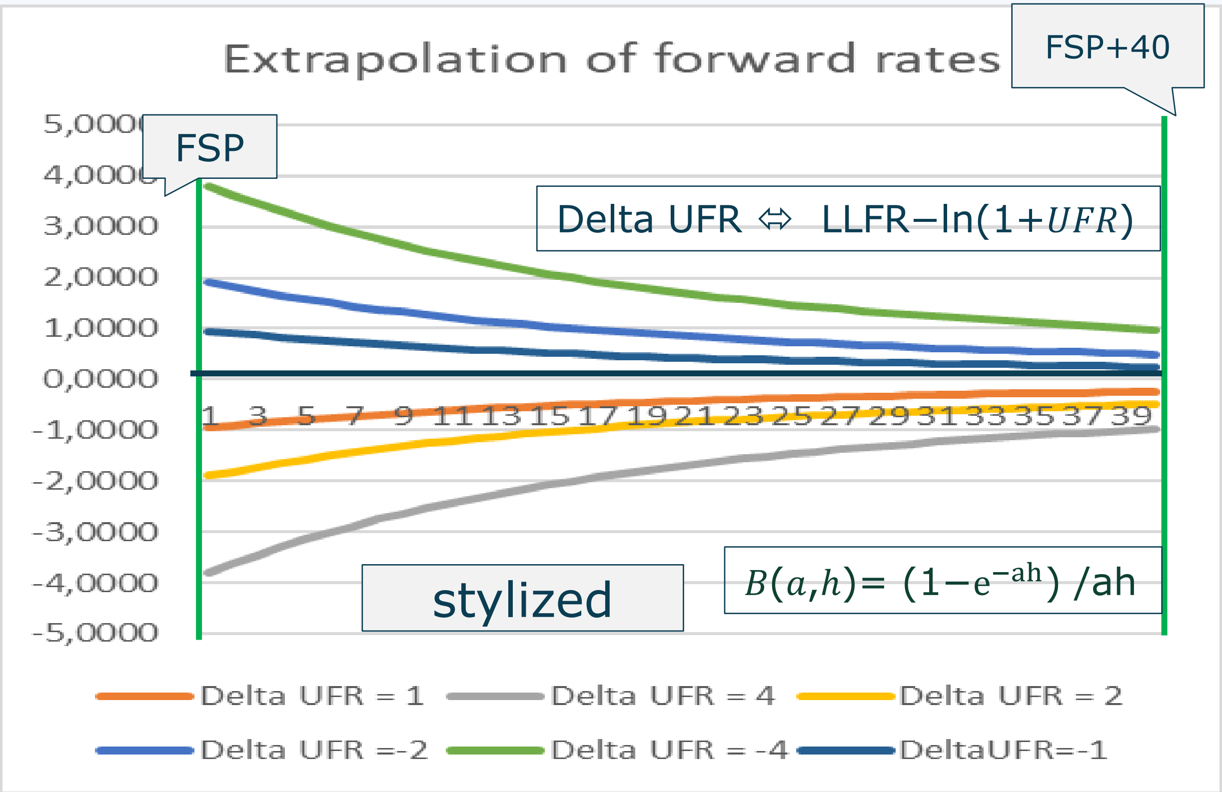
<u>Required parameters:</u>

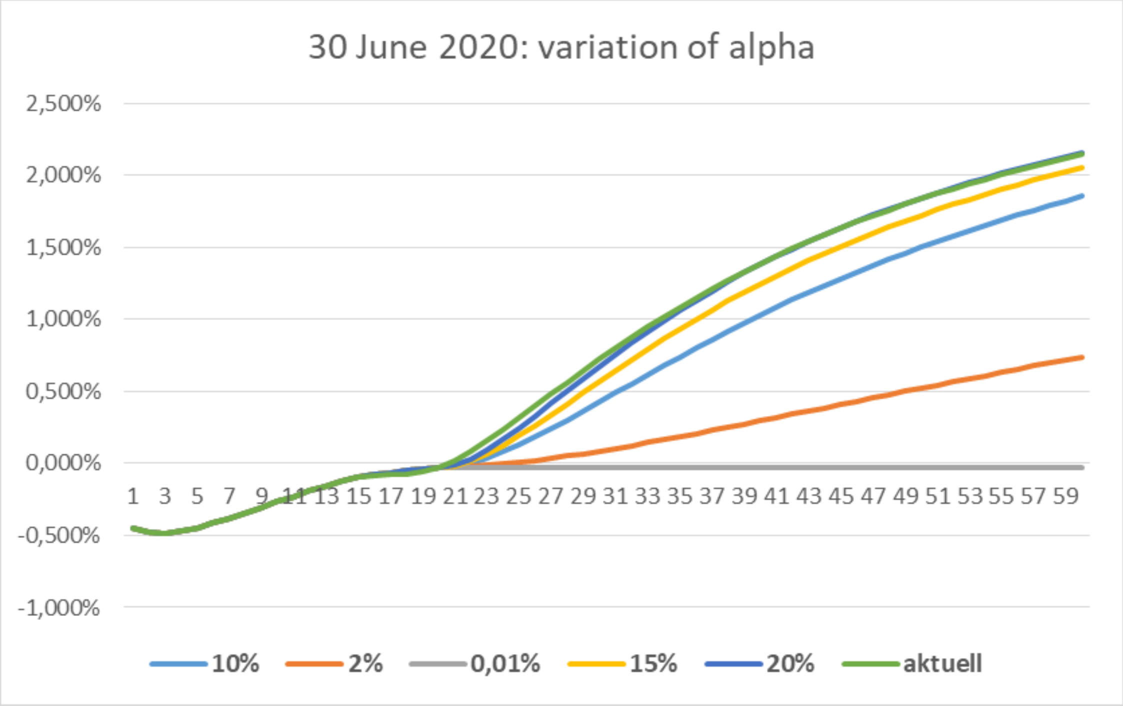
- A starting point and starting value for the extrapolation → residual volume criterion
- Long-term expectation or mean-reversion level → ultimate forward rate (UFR)
- Formula and parameters steering the convergence process (political decision needed)

Extraction: Difference between methodologies

Current method (Euro)	Proposed method	
Current method (Euro) LLP = 20 years (criteria: availability of bonds) Starting point for extrapolation Starting value: RFR(20) Convergence towards the UFR	**Proposed method** FSP = 20 years (criteria: availability of bonds) Starting point for extrapolation Starting value: LLFR (to consider DLT-Swap markets beyond FSP) Convergence towards the UFR	
Independent of starting value: after 60 years the extrapolated forward rates will reach the UFR with a tolerance of not more than 3 bp. (Smith-Wilson model used) Shape of curve (steepness) will be adapted Laid down in **Recital 30**, of Omnibus II-Directive	Extrapolation of forward rates $f_{20,20+h} = \ln(1+UFR)+(LLFR-\ln(1+UFR))*B(a,h)$ $B(a,h)= (1-e^{-ah})\ /ah$ h = maturity after FSP a = convergence factor (10%) Zero-coupon rates post FSP extrapolated: $z_{20+h} = \exp\left(\frac{20*z_{20}+h*f_{20,20+h}}{20+h}\right) - 1$ (LLFR introduced to consider information from DLT-Swap markets beyond FSP)	▪ Rates determined by convergence parameter Alpha (proposed value: 10%) and the difference $LLFR-\ln(1+UFR)$ ▪ No further requirements concerning convergence. ▪ Transition period (phasing-in) until 2032 proposed and included in **Article 77a**
Short-term market turmoil mitigated within the 40 years convergence period.		→ Short-term market turmoil carried forward to entire RFR

Convergence to UFR determined by LLFR and Alpha





Alpha (10%): Difference between LLFR and UFR determines convergence process of extrapolated forward rates

RFR: Proposed Phasing-in shall be steered by modification of Alpha

Alternative extrapolation of the RFR

Impact assessments: Alternative extrapolation proved to be the most significant change.

The low interest rate environment revealed some weak aspects of the method.

- The formula-based method relinquishes the convergence criteria to the UFR.
- Short-term distortion of markets (market turmoil) is carried forward to entire RFR.

<u>Check of Commission's proposal against criteria:</u>

- Short term market turmoil is not sufficiently mitigated and affects significantly the capital position - especially of life insurers with long-term business.
  → long-term nature not appropriately reflected
- Risk of procyclical behaviour increased
- Artificial volatility increased

"No unequivocal evidence can be found in the economic empirical literature for the convergence factor and the existence of a convergence factor greater than zero is also often called into doubt."
EIOPA: Background document A.90

Approximate impact on capital surplus		
Changes to	HIA	CIR
Volatility adjustment	+16 bn	+13 bn
Risk margin	+16 bn	+18 bn
Extrapolation	-34 bn	-61 bn
Correlations	+ 5 bn	+5 bn
Interest rate risk	-21 bn	-20 bn

Two holistic impact assessments performed by EIOPA:
- Holistic Impact Assessment (HIA): 31 December 2019
- Complementary Information Request (CIR): 30 June 2020

Proposals with highest expected impact tested. Repeated without interest rate risk.

Symmetric adjustment to equity risk charge

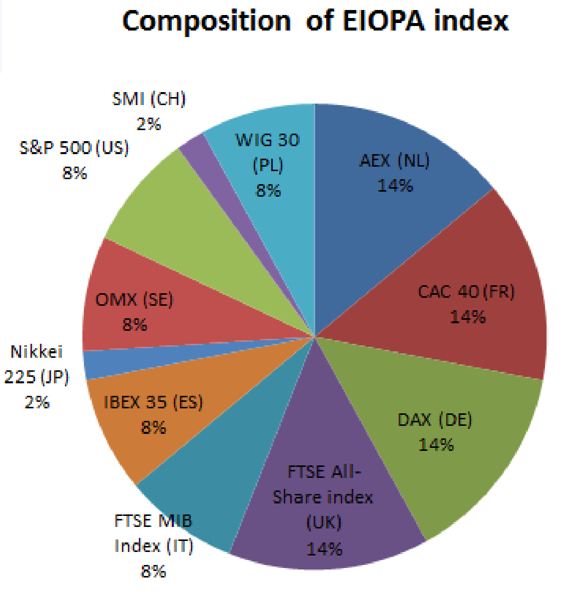
Commission's request: *EIOPA is also asked to ….assess the appropriateness of the design and calibration of ….. and of the symmetric adjustment (SA).*

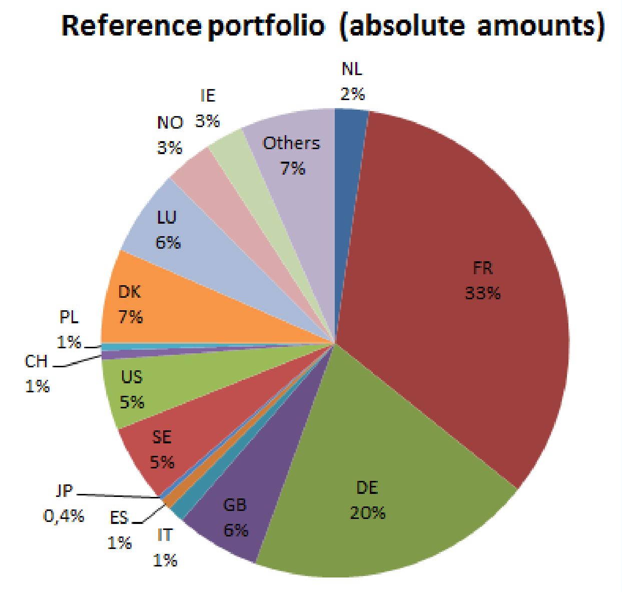
$$SA = \frac{1}{2} \cdot \left(\frac{CI - AI}{AI} - 8\% \right) \text{ where}$$

a) CI denotes the current level of the equity index

b) AI denotes the weighted average of the daily levels of the equity index over the last 36 months.

The symmetric adjustment shall not be lower than – 10 % or higher than 10 %.



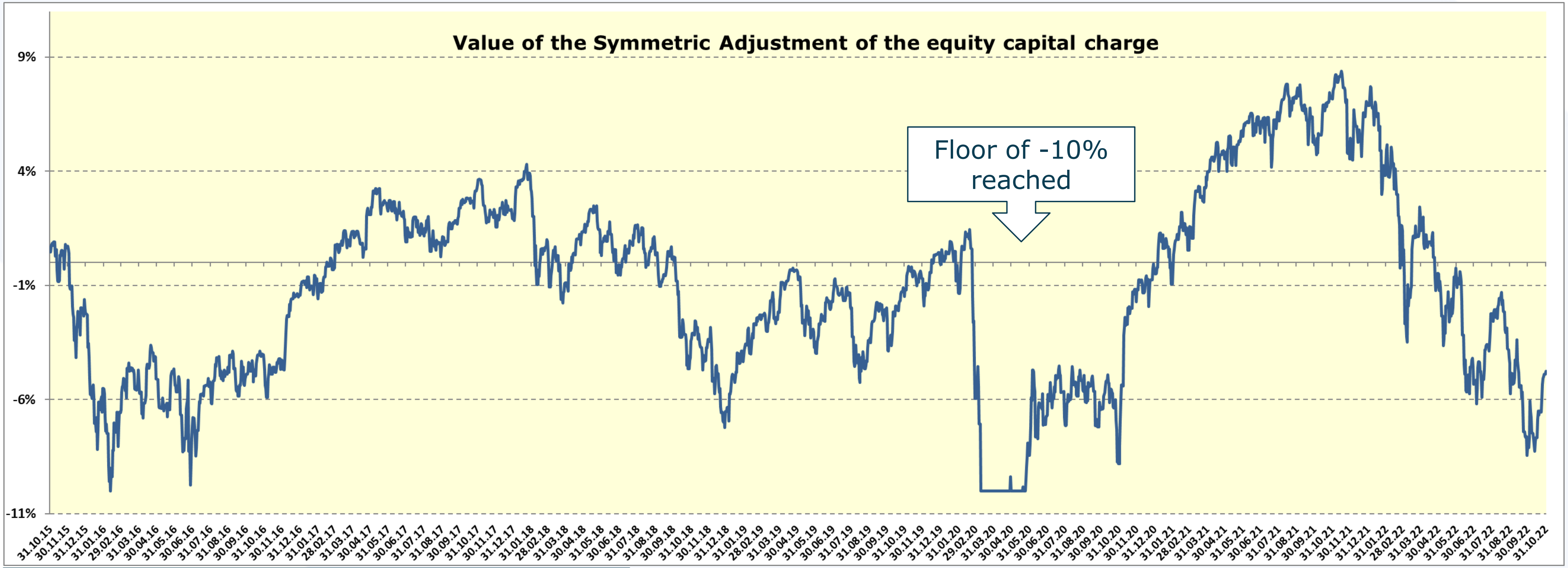


Delegated Regulation: Article 172 (1(a))

The equity index measures the market price of a diversified portfolio of equities which is representative of the nature of equities typically held by insurance and reinsurance undertakings;

Symmetric adjustment of equity capital charge

Current corridor -10%/+10% → changes considered by EIOPA



31 October 2022: -4.76%

https://www.eiopa.europa.eu/media/news/monthly-update-of-symmetric-adjustment-of-equity-capital-charge-solvency-ii-%E2%80%93-end-october_en

Volatility adjustment (VA)

Rationale:

- Asset allocation of insurers is liability-driven
- Assets can be hold long-term
- Short-term changes in credit spreads can be mitigated.
- VA can reduce short-term volatility.

Calculation of the volatility adjustment:

spreads derived from currency-specific reference portfolio
Risk-correction of bond-spreads to consider risks of default, cost of downgrade
Application ratio to calculate the VA

VA applied to the liquid part of the RFR

EIOPA’s identified risks in current regulation, e.g. overshooting

Volatility adjustment (VA)

<u>Current regulation:</u>

$$VA = \mathbf{65\%} \cdot RCS$$

- VA calculated as 65% of risk-corrected spread
- Spread determined for corporate and government bonds
- Risk-correction by use of long-term average spread (like fundamental spread)
- Country component for eurozone added

Commission's proposed amendment deviates from EIOPA's more elaborated advice:

$$VA = \mathbf{85\%} \cdot CSSR \cdot RCS$$

- Introduction of a credit spread sensitivity ratio (CSSR)
- CSSR undertaking-specific, to consider asset-liability mismatch
- VA equals 85% of risk-corrected spread multiplied by CSSR
- Risk-correction de-coupled from fundamental spread, consider current spread
- Macroeconomic VA added (country specificities in eurozone)

Approval by supervisors required for **<u>new</u>** users of the VA

Long-term equity investment (LTEI)

<u>Commission's Action plan</u>:
<u>Participation of insurers in long-term investments, in particular equity</u>, *can be supported by 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.*
<u>Action 4:</u> *The Commission will seek to remove regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection.*
(Source: https://ec.europa.eu/finance/docs/law/200924-capital-markets-union-action-plan_en.pdf)

Insurers shall help to finance the Green Deal and other European projects.

A preferential treatment of LTEI shall support this goal.

The asset-class LTEI was introduced in 2019 in the Delegated Regulation (Art. 171a).

The stress for this asset class is reduced to 22% for listed and unlisted equities as well.

Regulatory obstacle: eligibility of equities and administrative limitations restrained the use of this asset class.

Long-term equity investment (LTEI)

LTEI is currently a level 2-issue.

Amendments not considered in Commission's proposal and in Council's compromise paper.

Rapporteur:
Provide more details in the Directive. New article 105a proposed.

Commission "considers" adaptation of Delegated Regulation, taking into account EIOPA's advice in its opinion from December 2020

Eligibility:
- Treatment of equity investments as "long-term": simplification of conditions considered
- Goal: expand the scope of equities that can be subject to the more favourable 22% risk factor (instead of the reference 39% for listed equities and 49% for unlisted equities).

Management of the asset class
- No ring-fencing should be required
- Holding-period requirements should be lowered (currently 10 years)

Risk management:
- High importance: management of liquidity risk

Policyholder protection
Framework for LTEI should remain prudentially robust, and not impair policyholder protection and financial stability

Risk margin: significant reduction considered

Technical provision (TP) = best estimate liability + risk margin (if TP not calculated as a whole).

Two components of risk margin: the cost of capital-rate and the present value of future SCR

EIOPA proposed a modification of the current formula: the lambda approach

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

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

The floor of 0.5 is effective for durations longer than 27 years.

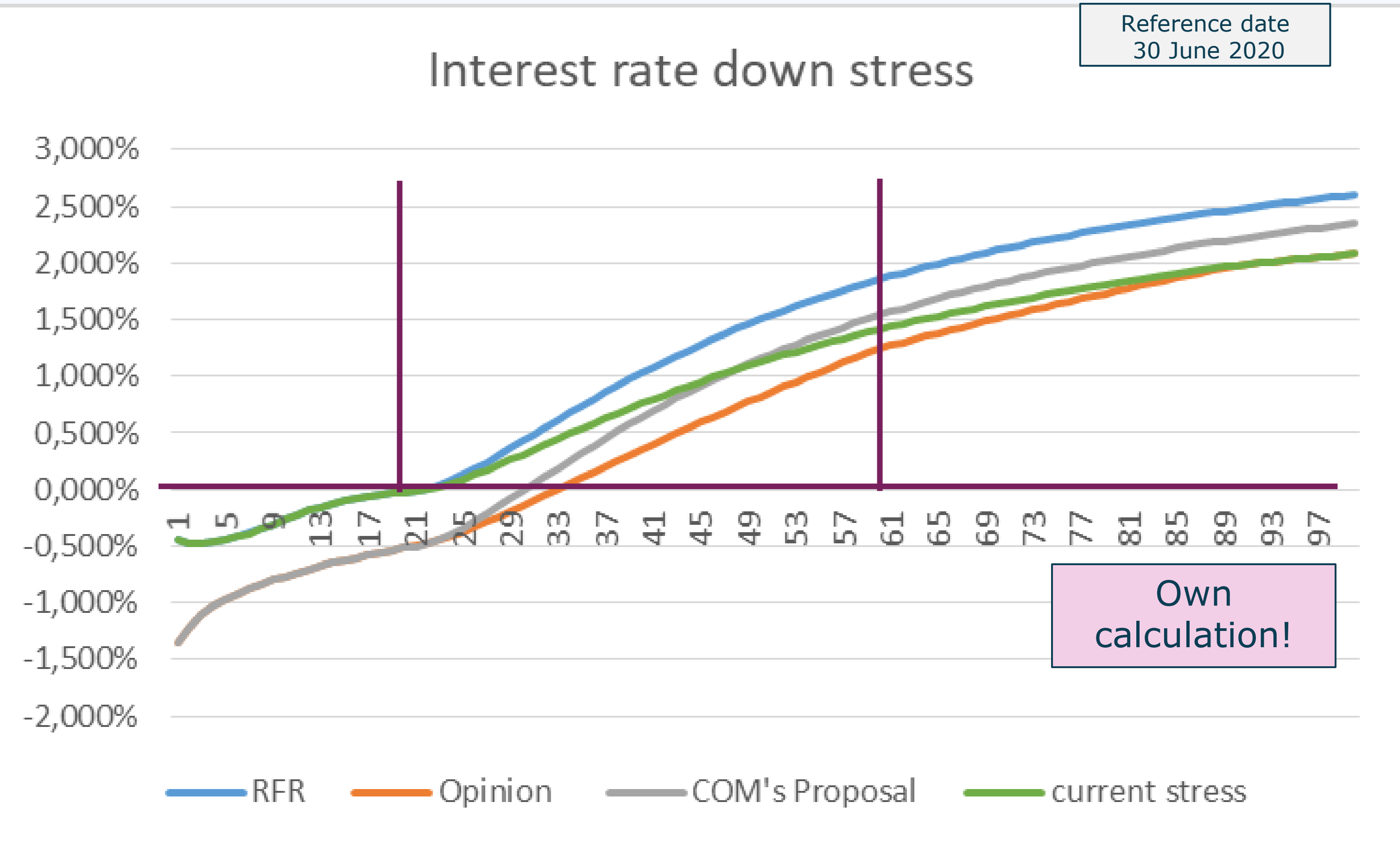
Commission considers building on the lambda approach but removing the floor and reducing the CoC-rate to 5% (→ delegated act)

Under discussion now: The factor lambda, the floor and the CoC.

Lower CoC-rates and other proposed changes will result in a material capital relief.

To ensure: Capital relief and policyholder protection must be well balanced.

Interest rate down stress needs recalibration



Interest rate risk module

- No stress applied if on negative interest rates.
- Stress is applied to the extrapolated RFR.

<u>AAE's position:</u>

- The shifted approach proposed by EIOPA is basically supported.
- But: stress should only be applied to the liquid part of the RFR.

<u>First stress – then extrapolate</u>

A phasing-in period can facilitate a smooth implementation.

Solvency II 2020 review - agenda

1) Background and stock-taking
2) Review process and proposed amendment
    a) Proportionality: lower administrative burden
    b) Macroprudential issues
    c) LTG measures

3) Recovery and resolution

Insurance Recovery and Resolution Directive (IRRD)

Solvency II is not a zero-failure regime!

Reasons for a separate directive

- Disorderly failure can pose risks to financial stability and to policyholders
- Regular insolvency procedure might be cumbersome and unable to manage a failure of an insurer in an orderly fashion. E.g., the settlement of policyholders’ claims could be considerably delayed
- A specialized authority, familiar with the challenges of resolution, and equipped with a set of specific tools, would be best placed to deal with situations of distress and default of insurers.

Objectives:

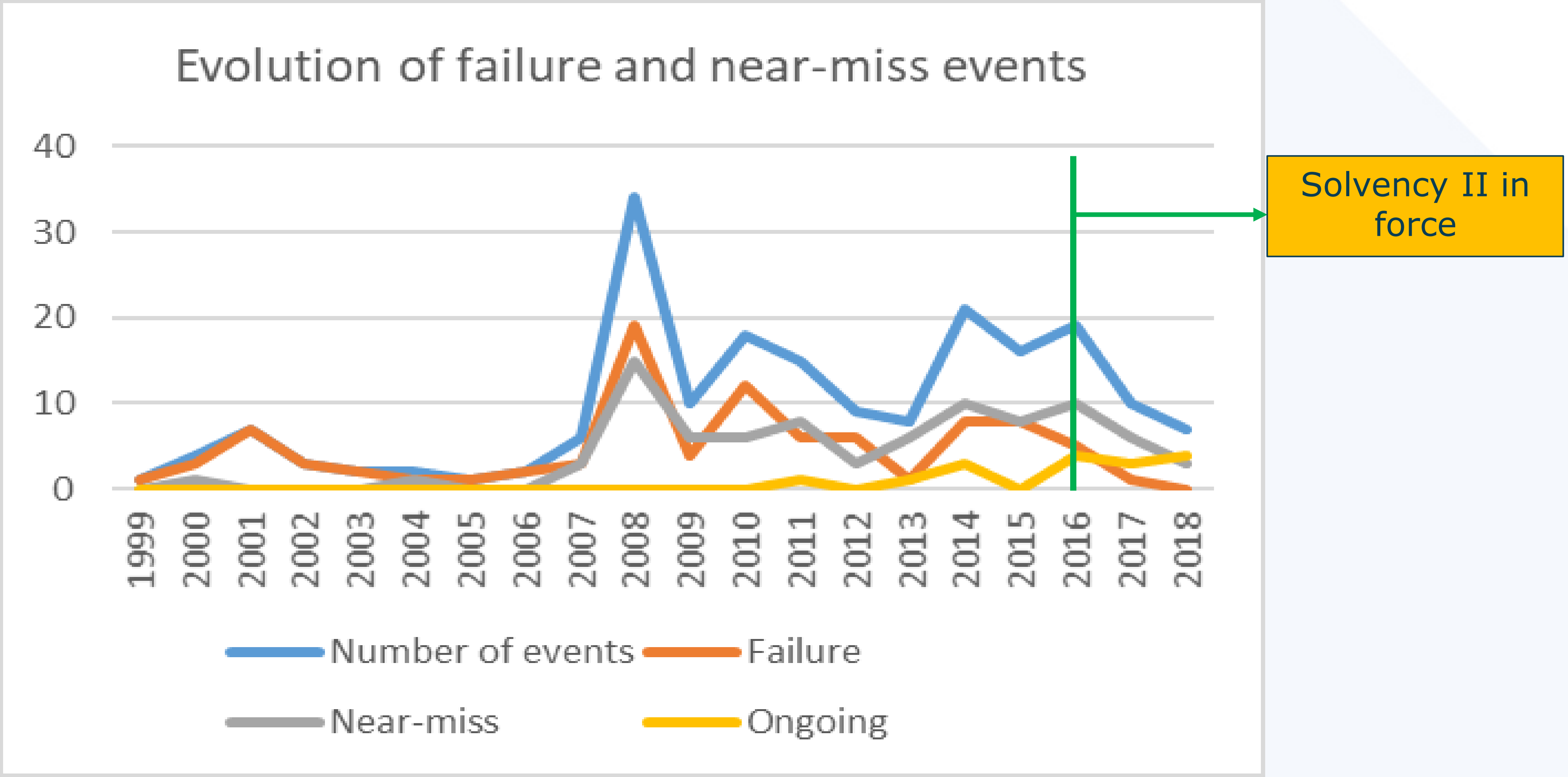
- Preparedness to cope with significant financial distress and to mitigate fallouts
- Prevent policyholder detriment e.g., by continuing to pay out claims and pensions
- Provide national authorities with tools to safeguard policyholders and protect real economy, financial stability and taxpayers through an orderly resolution process for failing insurers

IRRD shall

- be fully consistent with the SII framework
- complement the revised SII framework, strengthen the trust in the insurance sector
- prevent failure - and if this is not possible - facilitate an orderly market exit (ultimate goal)

Failures and near misses

Solvency II is not a zero-failure regime!
But it can reduce the risk of failures



Source: Commission's impact assessment see Annex 5 - IGS

IRRD proposals

Recovery	Resolution
Undertakings shall prepare and regularly update pre-emptive recovery plans (assessed by supervisory authority): – Minimum market coverage: **80%** – LRUs excluded – Consideration of proportionality aspects – Assessment against a set of scenarios – Approval of the plan by AMSB Plans should contain a framework of qualitative and quantitative indicators that identify the points at which remedial actions should be considered. Guidelines and RTS requested for further specification.	Resolution authorities with harmonized set of powers to undertake all relevant preparatory and resolution actions. Resolution authority shall prepare resolution plans setting out resolution actions: - Minimum market coverage: **70%** - LRUs excluded - proportionality criteria, including the expected impact of their failure - Specification of options for resolution should consider resolution scenarios - Annual review Guidelines and RTS requested for further specification.

Plans should not rely on extraordinary public financial assistance or expose taxpayers to the risk of loss.

IRRD: AAE position

Pre-emptive recovery planning

A formal requirement to create recovery plans might be excluded from the planned IRRD.

- Pillar II and Pillar III of the Solvency II framework of Solvency II are well developed and require
  - broad consideration of risks in the ORSA and
  - far-reaching disclosure requirements to supervisors and public as well.
- If necessary, Guidelines can be issued to further clarify SII requirements

IRRD parts relating to recovery should not compete with existing SII regime

Resolution:

- A harmonised resolution process could be beneficial for policyholders and superior to a winding-up under national insolvency proceedings
- Especially cross-border business or conglomerates might deserve attention
- Resolution plans should not be provided based on a market coverage ratio.
- They should be based on risk factors (of failure, or the impact of failure).
- To ensure a harmonised treatment by NSAs, guardrails could be set down in the IRRD

Resolution: objectives and tools

Objectives of resolution (IRRD, Article 18)

(a) protecting policyholders, beneficiaries and claimants;

(b) maintaining financial stability, in particular, by preventing contagion and by maintaining market discipline;

(c) ensuring the continuity of critical functions;

(d) protecting public funds by minimising reliance on extraordinary public financial support.

The way to resolution: Supervisor's assessment will start the process if

1) an undertaking is assessed as likely to fail or in case of a failure
2) No reasonable prospect of recovery is identified

Resolution authority involved: To decide: Liquidation of the undertaking or go into resolution

(To respect: "no creditor worse of off than under normal insolvency proceedings" principle)

Open question: resolution funding

https://www.eiopa.europa.eu/document-library/discussion-paper/resolution-funding-and-national-insurance-guarantee-schemes_en

Proposed amendments: urge EIOPA/Commission to clarify funding of resolution **and** IGS

Resolution: objectives and tools

Five resolution tools considered:

(a) the solvent run-off tool;

(b) the sale of business tool;

(c) the bridge undertaking tool;

(d) the asset and liability separation tool;

(e) the write-down or conversion tool.

Member States: Ensure that resolution authorities have the necessary powers to apply these resolution tools.

Cross-border business: Resolution colleges required, EIOPA shall be invited to attend

Not in the IRRD – but requested by EIOPA and proposed in several amendments to the IRRD

→ Consideration of insurance guarantee schemes (IGS) – new Article 82 a proposed.

Existence of IGS for eligible policyholders or beneficials can affect the chosen resolution tool.

IGS: EIOPA’s view

Every member state should have a national IGS in place.
Exact structure left to the discretion of member states.

Role and functioning of IGS
An IGS should have the primary aim to protect policyholders, which can be achieved by:

i) paying compensation swiftly to policyholders and beneficiaries for their losses when an insurer becomes insolvent; and/or

ii) ensuring the continuation of insurance policies (for instance, by funding or promoting a portfolio transfer or taking over and administrating the portfolio)

Harmonisation should be based on the home-country principle

Analysed but not taken up by the Commission (exclusion justified by expected costs)

Commission’s impact assessment: *The cost of introducing IGSs would be around EUR 21 billion, which would be partly passed on to policyholders through increased premiums. The review would generate moderate implementation and administrative burdens.*

https://www.eiopa.europa.eu/sites/default/files/publications/opinions/eiopa-bos-17-148_opinion_on_recovery_and_resolution_for_reinsurers.pdf actuarial association of europe

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