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Solvency II review and AAE's activities

AAE detailed work and positioning

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Many thanks to the AAE SII & Sustainability and Climate related Risk WG

23 November 2022

Agenda

- Detailed AAE analyses of current proposals from EIOPA and the trilogue parties on:
  - Extrapolation, IRR, VA
  - LTEI, SA
  - Risk Margin

- Review of proposed approaches on macroprudential
- Review of proposed approaches on sustainability
- Conclusions

Detailed AAE analyses

Extrapolation

EIOPA – European Insurance and Occupational Pensions Authority

- First Smoothing Point (FSP): 20Yr
- Alpha: 10% (depending on interest level observed when it becomes applicable)
- Application date of convergence parameters : 2032 (depending on interest rate. Potential disclosure in SFCR of sensitivity analysis with alpha = 5%)
- Convergence period: 40 Yr, tolerance level: 3bp from UFR

European Commission

- FSP: 20Yr
- Alpha: 10%
- Application date: 2032
- Convergence period: 40 Yr, Tolerance level: 3bp

European Council

- FSP: 20Yr
- Alpha: not yet discussed, just whether calibration should be determined in L1 or L2
- Application date: 2032
- Convergence period: 40 Yr, Tolerance level: 3bp

European Parliament

- FSP:
  a) **20 Yr**[1]
  b) 30 Yr
- Alpha:
  a) 5% or 10% under additional safeguards in pillar 2 & 3
  b) 10%
  c) 18% (should be set in Directive)
  d) **20%**
  e) Sufficient convergence speed
  f) Disclose impact of 5%
  g) In line with MCV principles, details to be laid down in delegated regulation
  h) EIOPA to verify whether market conditions have changed since the last recalculation of alpha
- Application date:
  a) 2029
  b) 2030
  c) 2032
- Convergence period:
  a) 40 Yr
  b) **Appropriate convergence period**
- Tolerance level:
  a) **3 bp**
  b) 7 bp

1- Indicates Markus Ferber's proposal as rapporteur

Extrapolation – Your view and our view

Q1 – What do you consider as appropriate FSP?

a) 20 Yr
b) 30 Yr
c) Other please specify

Q2 – What do you consider as appropriate alpha?

a) 5% or 10% under additional safeguards in pillars 2 & 3
b) 10%
c) 18%
d) 20%
e) Sufficient convergence speed
f) Disclose impact of 5%
g) In line with MCV principles, details to be laid down in delegated regulation
h) EIOPA to verify whether market conditions have changed since the last recalculation of alpha

- FSP:
  a) 20 Yr - bond volume criteria
- Alpha:
  e) & h) - A higher alpha could avoid the transition period. It is quite dependent on the level of the LLFR versus UFR at implementation date
- Application date: It is an unnecessary burden. We should avoid cumulating transition periods such as the upcoming 5-Yr phasing in from SCR int and eventual use of transition measures on TP & RfR. This would result in difficulties in management steering and confusion in disclosures
- Convergence period: It should not be more than 40 Years in line with current regulation
- Tolerance level: both 3bp and 7bp tolerance levels are acceptable

Interest Rate Risk

EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

- Need for recalibration with shifted methodology
- Floor: -1.25%
- Transition: gradual implementation over 5 Yr
- Link with extrapolation: first extrapolate and then stress

European Commission

- Methodology: EC adopts EIOPA proposal
- Floor: EC adopts EIOPA proposal
- Transition: EC adopts EIOPA proposal
- Extrapolation: EC Introduces extrapolation of the stressed curves (UFR by -15bp)

European Council

- Methodology: Accepts EIOPA proposal
- Floor: Accepts EIOPA proposal
- Transition: **Mandatory** 5-Yr transitional measure. Impact transitional to be disclosed separately in SFCR
- Extrapolation: in line with EC

European Parliament

- Conditions for recalibration
  a) **Need to recalibrate IRR for low and negative rates to be achieved without market disruption[1]**
  b) Need to recalibrate IRR to reflect existence of negative yield environment
- Floor:
  a) **Requirement for a specific floor (not specified)**
  b) Need for an increasing term-dependant floor
- Transition: discretionary application of a 5-Yr transitional on the changes to the IRR SCR
- Extrapolation : Extrapolation methodology should be used in the IRR SCR calculation (in line with EC proposal)

1- Indicates Markus Ferber's proposal as rapporteur

IRR – Your view and our view

Q3 – What do you consider as appropriate floor?

a) -1.25%
b) Need for an increasing term-dependant floor
c) Other please specify

Q4 – Should the 5 Yr-transitional be?

a) Discretionary
b) Mandatory
c) Other please specify

- Need for recalibration:
  Support shifted methodology given the need to recalibrate IRR for low and negative rates, this should be achieved without market disruption
- Floor: some considerations
  - A strict floor would help to stabilize, a time dependant floor would make sense and such a scenario would be more aligned with the LT business model of insurers
  - There should be an absolute shock when you are in a very negative territory as you have much lower volatility
- Transition: some considerations
  - Most transitionals are usually discretionary except alpha convergence under the new extrapolation method
  - Mandatory transition fosters better comparison but makes it more complex
- Extrapolation: support EC proposal to take the stressed curve and then extrapolate

Volatility Adjustment

EIOPA (European Insurance and Occupational Pensions Authority):

- GAR: increase from 65% to 85%
- Bond portfolio normalization: VA ref portfolio = 100% fixed income assets
- Duration ratio
- Liquidity ratio (100%/75%/50%)
- Own asset approach: not introduced
- RCS = f(CS,LTAS)
- Supervisory approval for new users
- RM: perform sensitivity of TP & OF to changes in economic assumptions that would affect the RCS, include the VA in the risk management policy

European Commission:

- GAR: 85%
- Bond portfolio normalization (assumed)
- Duration ratio
- No liquidity ratio
- No own asset
- RCS= f(LTAS) (assumed)
- Supervisory approval: EC adopts EIOPA proposal
- RM: EC adopts EIOPA proposal

European Council:

Same as EC except on

- Own asset approach: introduction of Basis Risk Correction (overshooting capped at 100%)
- Supervisory approval: extension of supervisory approval process to permit additional national criteria

European Parliament:

- GAR: 85%
- Bond portfolio normalization
- Duration ratio
- Liquidity ratio:
  a) **No liquidity ratio**
  b) Liquidity ratio
- Own asset:
  a) **No own asset approach**
  b) Optional overshooting adjustment is proposed subject to 100% cap
  c) Overshooting capped at 150% subject to criteria
  d) Overshooting with a floor of 75% and cap of 125%
- RCS methodology to be:
  a) **same manner as the fundamental spread**
  b) function of the LTAS and current spread level
  c) countercyclicality function of VA should be reflected in the RC methodology

1- Indicates Markus Ferber’s proposal as rapporteur

VA – Your view and our view

Q5 – Should the VA include a liquidity ratio?

a) Liquidity ratio
b) No liquidity ratio
c) Other please specify

Q6 – Should the VA include an own asset component?

a) No own asset approach
b) Optional overshooting adjustment subject to 100% cap
c) Overshooting capped at 150% subject to criteria
d) Overshooting with a floor of 75% and cap of 125%

Q7 – what is your opinion on the RCS approach?

a) same manner as the fundamental spread
b) function of the LTAS and current spread level
c) countercyclicality function of VA should be reflected in the RC methodology

- GAR: 85%
- Bond portfolio normalization
- Duration ratio
- Liquidity ratio:
  b) Support liquidity ratio in theory. The practical implementation is however complex. This should be considered together with the liquidity risk management process incl. additional safeguards in pillar 2
- Own asset:
  Own VA, with appropriate safeguards, can coexist with EU VA and should be part of the risk management system together with ORSA to be communicated to the supervisor.
  BRC could be considered in a transparent and risk-based approach (cap to be justified) but eventual double-counting with duration and liquidity ratio should be avoided. We should keep proportionality in mind.
- RCS
  c) countercyclicality function of VA should be reflected in the RC methodology The risk-correction of the observed spreads should consider the long-term nature of life insurance business. Currently, this is achieved by taking the long-term average spread as a measure. If daily spreads were considered, as proposed by EIOPA, volatility would be excessive.

Equity

EIOPA – European Insurance and Occupational Pensions Authority

- Symmetric Adjustment (SA)
  - Increase the corridor from +/- 10% to +/- 17%
  - No min
- LTEI: proposed a set of criteria which are understood to work for some markets following some minor adaptations

European Commission

- SA
  - Increase the corridor from +/- 10% to +/- 17%
  - No min
- LTEI: Definitive proposal will be known only when Delegated Acts starts to be drafted. However some ideas have been circulated inspired by EIOPA's position on the review:
  - Deletion of "pseudo ring-fencing"
  - Refining of the liquidity criteria
  - Change in the 5 years detention measure

European Council

- SA
  - Keep the corridor at +/- 10%
  - No min
- LTEI: Definitive proposal will be known only when Delegated Acts starts to be drafted. However some ideas have been circulated inspired by EIOPA's position on the review:
  - Deletion of "pseudo ring-fencing"
  - Refining of the liquidity criteria
  - Change in the 5 years detention measure

European Parliament

- SA – corridor
  a) **Modify range to an asymmetric corridor from -17% to +10% (in relation to equities not covering UL)**
  b) Exclude UL and limit corridor to +/-10% Floor:
- Capital charge – min
  a) Proposal of a floor to equity charge of 15%
  b) Proposal of a floor to equity charge of 20%
- LTEI: Switch from L2 to L1. So far, Current phrasing of 171a is kept ("ring-fencing" & strict holding period requirement).

1- Indicates Markus Ferber's proposal as rapporteur

Equity – Your view and our view

Q8 – What should be the value of the SA?

a) +/- 10%
b) +/- 17%
c) -17%; +10%
d) Other please specify

Q9 – Should the SA not apply on unit-linked?

a) Yes
b) No
c) Other please specify

Q10 – What should be a min SCR equity?

a) 15%
b) 20%
c) 22%
d) None
e) Other please specify

Q11 – What is the most restrictive condition for the LTEI use (please rank)?

1. Ring-fencing
2. Liquidity conditions
3. Holding period criteria
4. Scope limited to assets backing liabilities
5. Other please specify

- SA - some considerations
  17% may be overshooting as everything is proportional.
  Equities can show different up and down patterns, supporting an asymmetric treatment.
  A differentiated/excluded treatment for unit-linked can be justified as policyholders bear the risk and 3-Yr average lead to abnormal value creation/destruction for those specific policies

- LTEI –some considerations
  This should remain at L2 level
  Support EIOPA & commission proposal : The main topic remaining is the “liquidity criteria” : it should remain risk based and promote sound risk management
  Reject Ferber's proposal (strict conditions equivalent to ring-fencing, strict link between sub-assets & sub-liabilities over time, limited to TP, LT holding criterion based on a constraint of min 5Yr average holding period of invested securities rather than overall exposure commitment in a policy)
  Support efficient liquidity risk management

Risk Margin

- CoC Rate: 6%
- Lambda factor: 0,975 and floor of 0,5

- CoC Rate: 5%
- Lambda factor: 0,975 without floor

- CoC Rate: 5%
- Lambda factor: 0,975 without floor

- CoC Rate:
  a) 6%
  b) 4,5%
  c) **4%**
  d) Calibration set by EC set on EIOPA's opinion
  e) Should not be lower than 5%
- Lambda factor:
  a) **0,9 without floor**
  b) 0,975 and floor of 0,5
  c) 0,995 without floor and CoC of 6%

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Risk Margin – Your view and our view

Q12 – What is an appropriate CoC?

a) 6%
b) 4,5%
c) 4%
d) Calibration set by EC set on EIOPA's opinion
e) Should not be lower than 5%
f) Other please specify

Q13 – What is an appropriate lambda factor?

a) 0,9 without floor
b) 0,975 without floor
c) 0,975 and floor of 0,5
d) 0,995 without floor and CoC of 6%

- CoC Rate
  f) calibration based on EIOPA's opinion, e) should not be lower than 5%.
  The approach should remain risk-based. In terms of level and based on WACC arguments across the industry, a 6% CoC rate might be too high. We also note that ICS Version 2.0 included a fixed 5% CoC as one of its proposals.

- Lambda factor
  b) 0,975 without floor
  There is no good justification for a floor as lambda reflects a risk dependance through time. We observe an inverse relationship between lambda and CoC for some risk components. If CoC=5%, lambda = 1-50%*CoC=0,975 is defendable

Macroprudential

Review of proposed approaches

Macroprudential tools (1/2)

- **Liquidity Risk Management Plans (LRMP)**
  LRMP where insurers other than LRPU identify, monitor and address potential liquidity risk (VA/MA liquidity analysis can be included in LRMP)
  VS Only at supervisors' request
  VS More or less prescriptive

- **Supervisory powers in exceptional liquidity situations**
  E.g. temporarily suspend redemption rights of life insurance policyholders with subsequent impact on dividend distributions, bonuses and variable remuneration
  VS no additional powers
  VS only be applied temporarily and only when there is an imminent risk of non-compliance with SCR
  VS NSAs to justify the application of their powers
  VS NSAs powers restricted to max 3 months, while EIOPA and ESRB have the power to intervene in case of disproportionate NSA approach
  VS NSAs shall inform macroprudential supervisors, EIOPA and ESRB in a timely manner of use of macroprudential tools. Suspension of redemption right of life Policyholders can be applied to some, and not all, undertakings

- **LRMP**
  LRMP should **not be too prescriptive**: this has to be seen in conjunction with Risk Management of the enterprise. Proportionality and materiality should be considered. VA remains important

- **Supervisory powers in exceptional liquidity situations**
  Powers should only be applied **temporarily and only in exceptional circumstances**.
  It limits the decision power of the Management Board and should be considered together with **IRRD**. Such an assessment should be included in **ORSA**.

Macroprudential tools (2/2)

- **Supervisory powers to preserve financial position during exceptional market-wide shocks**
  New intervention powers before SCR is breached, such as restricting or suspending dividends and other shareholder payments "during periods of exceptional sector wide shocks" but on a case-by-case basis
  VS No additional power
  VS Trigger point to be "exceptional adverse situations" and NSAs to intervene to all undertakings and not only vulnerable ones
  VS NSA power should not be discriminatory, when applied to one undertaking

- **Macro considerations in ORSA and PPP**
  Integration of macro risk in ORSA
  VS Reduced scope only at supervisor's request, nature/scale/complexity to be considered, subsidiaries can be exempted in case of group ORSA
  VS Significant streamlining of the EC's proposed requirements
  VS Extension of macroprudential considerations in ORSA to include geopolitical, environmental, pandemics, biodiversity loss.
  VS Extension of macro consideration to require undertakings to consider cumulative impacts of wider insurance market.
  VS MS shall ensure that NSAs share 'in due course' the findings of their macroprudential assessments of the ORSA

- **Capital add-on for system risk**
  MS shall ensure that NSAs, in agreement with EIOPA, should be able to impose a capital add-on for system risk, when they assess activity or behaviour based sources of systemic risk

- **Supervisory powers to preserve financial position during exceptional market-wide shocks**
  - New intervention powers should be limited to **exceptional circumstances** in case of significant under reserving or undercapitalization risk.
  - To protect the system, it is **more efficient** to apply such a measure at **sector level** but it can be penalizing for the well performing companies and their investors.
  - A **global framework with NSA power** might be the best way to tackle different situations.
  - The **2-layer protection** level with the SCR and MCR coverage should be considered when setting up the trigger. The interaction with **IRRD** should be considered.
- **Macro considerations in ORSA**
  Support: Extension of **macroprudential considerations** in ORSA to **include geopolitical, environmental, pandemics, biodiversity loss**.
  We need some guidance from supervisors as to issues that would affect the whole economy. Proportionality is key.

- **Capital add-on for system risk**
  Not in favour: lack of clarity on calibrations, the scope of macro-risks covered (behavioural-based, entity-based, activity-based). Also identified as problematic in ICS. More work needed to practically identify and assess systemic risk

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Sustainability

Review of MEPs proposed approaches

Sustainability - General

EIOPA – EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

Recommendation to recalibrate the natcat parameters on a frequent basis and to introduce climate change scenarios in the ORSA

European Commission

In line with EIOPA and includes a mandate for EIOPA to report on whether Green Supporting Factor/Brown Penalizing Factor can be justified on a risk basis.

European Council

- New EIOPA mandate to assess biodiversity loss risks (as well as GSF/BPF factors)
- Reduced frequency of recalibration of natcat parameters to 5 years
- Clarification that EIOPA mandate on the GSF/BPF is not only on the assets side but include the liabilities.
- ESAs to develop guidelines ensuring common standards for assessment methodologies for stress testing of ESG risks

European Parliament

Significant differences between June and August versions:

- June: Cancelling climate risk and sustainability
- August: Long list of amendments to sustainability risk, climate change risk reflecting the political preferences, some referring directly to CSRD

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Support review CAT NAT and climate ORSA. CSRD is a different regulation that should coexist with appropriate consistency with the SII framework

Sustainability (1/3)

- **EU Green Deal Interactions with prudential framework**
  a. Removal of sustainability articles and recitals
  b. Insurance framework to be updated to allow for climate and environmental risk mitigation and to reflect sustainability risks in underwriting and investment decisions
  c. Reference added to EC estimation on required investments (260 bln) to reach 2030 energy and climate target and insurance sector's role in achieving it.
  d. Higher risk of fuel exposures should also be reflected
  e. New recital noting the need for a transition plan to ensure business model/strategy is in line with Paris Agreement.
- **ORSA - scope**
  a. Removal of requirement for climate risk in ORSA
  b. Added requirement for all undertakings, regardless of materiality of their exposure, to carry out climate scenario analysis as part of their ORSA. Exemption for LRPUs is removed.
  c. To be excluded from carrying out climate scenario analysis, undertakings should prove that they have no material exposure to climate risks.
  d. Macroeconomic and financial markets' developments should be considered cumulatively when combined with similar actions by other undertakings.
  e. Inclusion and assessment of geopolitical and environmental developments and undertakings shall have processes in place to identify and assess all material risks.

- **EU Green Deal Interactions with prudential framework**
  b) & e) fit very well in the climate ORSA
  Same risk, same capital is important but it is not enough to look at your own Balance Sheet. We should avoid creating systemic risk while we note there is no approach today for the risk insurers create (any macro buffer on systemic risk)
- **ORSA - scope**
  support c), d) & e)
  Notes:
  - What is at stake here is not directly a change in the prudential framework, but a mandate for EIOPA to investigate whether such a change is necessary. We strongly support this mandate
  - Biodiversity loss is expected to be prominent in the future and has the risk of double-counting with climate

Sustainability (2/3)

- **ORSA – changes in assessments & scenarios**
  a. Increased the number of climate change scenarios which the undertaking shall specify from 2 to 3, inclusion of scenario with increase 3ºC or ≥2ºC , modelling a period of at least 30 years
  b.. Replaced long term climate change scenario where temperature increase is below 2˚ with "a long-term 'orderly transition' climate change scenario where climate change policies are introduced early and become gradually more stringent resulting in GHG emissions reaching net zero by 2050 and limiting temperature increase to below 2˚
  c.. Added a 'disorderly transition' scenario with delayed or divergent climate policies leading to later/sharper GHG emissions reductions and limiting temperature increase to below 2˚
  d. Change in the second scenario wording from equal or higher than 2ºC to significantly higher than 2ºC.
- **SII framework reflecting environmental risk**
  a. Deletion of recital on EIOPA mandate to report on a separate prudential treatment for green/brown investments and the regular recalibration of natcat standard parameters
  b. EIOPA to monitor and report on the risk profile of environmentally or socially harmful investments, and on biodiversity loss and advice on changes to directive. Inclusion of fossil fuel-related assets in the EIOPA report
  c. Undertakings to create transitions plans to adhere EU's Climate Law and removal of EIOPA mandates.
  d. EIOPA to inquire sustainable investments' recovery rates and assess if these could be integrated in the MA/VA calculation.
  e. Requirement for transition plan to climate neutrality by 2050. Requirement to report the transition plan to NSAs.

- **ORSA – changes in assessments & scenarios**
  Alignment with NGFS scenarios is best practice. We should avoid being too much prescriptive with reference to fixed values given the strong evolutions:
  - Currently, our baseline needs to be aligned with the UN climate report expectation of 2.4-2.6 degrees, and be updated as this external source changes
  - 1.5 degree orderly (NGFS) seems off the table, and both 1.5 and 2 degree would be a high transition risk scenario
  - .A 3 degree world has physical risk. but importantly, we already have significant physical risk in a 2.4 degree world for hothouse world
  - Europe will likely face - both physical and transition - where we are exposed to extreme physical as well as transition risk (as experienced in 2022)
- **SII framework reflecting environmental risk**
  NO support for a) & d)
  Transition plans (e)) are a key component of long-term climate scenarios and it makes sense for NSAs to look at them in the ORSA context

Sustainability (3/3)

- **Additional elements to be specified in DR**
  a) min. standards and reference methodologies for the transition plans.
  b) specific, measurable targets based on scientific evidence.
  c) min. standards and reference methodologies on how undertakings should integrate sustainability risks and adverse impacts on sustainability factors into their risk management systems
- **Risk Management**
  a. Requirement to regularly assess underwriting, reserving and investment activities and ensure that undertaking's business strategy is aligned with climate neutrality target.
  b. Requirement to develop and adopt a transition plan and to include sustainability risks in risk management system. Risk management policy to also include sustainability factors and stewardship policy.
  c. The remuneration policy shall promote sound and effective risk management including the integration of sustainability risks in the risk management system. If a variable component is included in the remuneration policy, at least half of it shall be linked to the achievement of sustainability targets. EC to develop DA.
- **SCR**
  a. Market risk shall include sustainability risks stemming from climate related impacts on the undertaking and its assets, especially due to exposure on fossil fuel sectors.
  b. DA to be adopted by the EC on method and parameters for the capital requirement of climate-related financial risks in the case of fossil fuel asset exposures.

- **Additional elements to be specified in DR**
  Strong support for a) and b)
  We support guidance but not every exposure should be captured in the DR
- **Risk Management**
  Support a) & b), and the principle of linking variable remuneration to sustainability objectives (c)), but a minimum of 50% might be too prescriptive
- **SCR**
  Same risk, same capital. We should be cautions of the wording in the L1 given the strong evolutions. We support investigating the specific risks of the fossil fuel sector (with potential differences between coal/gas/oil).

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Conclusions

Conclusions

- Clear trends are identified w.r.t. values of LTG measures and risk margin
- Some follow up on parameters include
  - Extrapolation: alpha parameter
  - IRR: floor and mandatory/discretionary transitional
  - VA: liquidity ratio, BRC
  - Equity: SA value, LTEI conditions
  - RM: CoC, lambda
- Scope on macroprudential tools and sustainability in SII still presents a high level of uncertainty and should be considered together with the Risk Management System and the other applicable regulations
- The risk management system importance is significantly increasing
- AAE wants to be prepared to develop a position taking into account the recent evolutions from the trilogue parties

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