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ACTUARIAL ASSOCIATION OF EUROPE
ASSOCIATION ACTUARIELLE EUROPÉENNE

1 PLACE DU SAMEDI
B-1000 BRUSSELS, BELGIUM
(+32) 2 201 60 21
INFO@ACTUARY.EU
WWW.ACTUARY.EU

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## SOLVENCY II-REVIEW: MAIN POSITIONS OF THE AAE

Solvency II has proven to be a well-functioning risk-based framework. It ensured policyholder protection and financial stability in Europe even during the unprecedented low interest rate period. Nevertheless, regular reviews are necessary to consider relevant risks and political priorities appropriately. The amended Solvency II Directive proposed EU-Commission considers consequentially not only the mandatory review of long-term guarantee measures but also sustainability and macroeconomic aspects. In addition, politics are focussing on the role of insurers as investors and are aiming at a capital relief. Co-legislators are still preparing for trilogue-negotiations by developing their view on these proposals.

The AAE contributes to this development by providing objective, independent, professional advice on all matters of actuarial relevance and in pursuit of the public interest. Policyholder protection must not be jeopardised. Therefore, capital requirements must always consider risks adequately. Same risk should require same capital. The whole framework must remain principles based and should strengthen the role of the key functions in risk management.

**Long-term business, long-term investments**

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 both, the long-term business, and the risk-adequate treatment of long-term investments. In line with Commission's action plan, an appropriate valuation should mitigate the impact resulting from short-term market turmoil on the solvency position of insurers. This will reduce artificial volatility and reduce the systemic risk that might result from a pro-cyclical behaviour of market participants. An adequate capital requirement for long-term investments is necessary to support insurers' role as investors.

As market values for insurance obligations are not available, the calculation of technical provisions necessitates the use of a risk-free rate term structure (RFR), to discount projected cashflows also for contracts with very long durations. Financial instruments available in deep, liquid, and transparent (DLT) markets are used to determine the RFR. An extrapolation process is needed to prolongate the RFR to durations for which such a DLT-market is not available. The RFR directly affects the technical provision (best estimate and risk margin) and can be adapted by a volatility adjustment (VA). Extrapolation and VA are of paramount importance and have also to consider specifics of national business models.

a) Extrapolation requires the determination of a starting point and a model to perform the extrapolation. EIOPA's impact assessments proved that a reliable convergence of the extrapolated forward rates towards the ultimate forward rate (UFR) is crucial and can help to mitigate short-term market turmoil considerably. Such a requirement is laid down in recital 30 of the Omnibus II-Directive for the Euro. A modified methodology should ensure a convergence period of 40 years at most with a maximum predefined difference of the extrapolated forward rates to the UFR at the end of this period. A sufficiently high percentage of outstanding bonds with that or a longer maturity should be decisive for the choice of the starting point.

The extrapolation method should be flexible enough to cope with changing financial developments (including the unprecedented protracted low – and even negative – interest rate environment) and go without the proposed  transition period after entering into force would.

b) Volatility adjustment (VA): Insurance undertakings are not forced to react on daily spread changes. Risk of default and downgrade necessitate a correction of the observed spreads A risk-correction should consider the long-term nature of insurance business. Currently, this is achieved by taking the long-term average spread as a measure. Consideration of more up-to-date spreads could increase volatility.
Commission's suggestions to revise the VA are too complicated.  Additional complexity in the VA calculation must be supported by quantitative evidence that it is appropriate and traded off against possible value added.
It must be pointed out that the spread is determined from a currency-specific reference portfolio. This can significantly differ from undertakings' own assets. Hence, an accurately fitting value for the VA cannot be achieved. This weakness in the calculation of the VA cannot be eliminated completely by adding undertaking-specific elements to the formula.
Over- or understating of technical provisions by adding an improper VA to the RFR will remain a risk. This can and should be thoroughly analysed as part of undertakings' Own Risk and Solvency Assessment (ORSA).

c) The risk margin is a major component of the technical provisions and thereby directly affects the own funds of undertakings. It is the amount of own funds provided by investors to ensure a protection of insurance liabilities over their lifetime. The risk margin is calculated as present value of projected solvency capital requirements (SCR) for each future year multiplied by a cost of capital rate. The AAE supports the approach that the projected SCR should have a lesser contribution to the risk margin (lambda-approach).
Any change of the cost of capital (CoC) rate shall be underpinned by the observable information from the financial market relevant for the insurance industry. Investors' requirements are assumed to be consistent with risk charges observed in capital markets for investments in industries with highly regulated capital requirements.
A reduction of the CoC-rate will result in a considerable reduction of the risk margin and therefore in a material capital relief for long-term business. AAE will monitor the further discussion in this regard thoroughly. Capital relief and policyholder protection must be well-balanced.

**Long-term equity investment**

To strengthen insurers role as investors, Commission will seek to remove regulatory obstacles, without harming financial stability and policyholder protection.
We welcome the proposal of EIOPA in its opinion of 17 December 2020, which provides clear and effective guidelines for removing the obstacles that had hitherto hindered the full effect of the Long-term Equity Investment (LTEI) scheme, as well as that of the Commission which shows a similar analysis of the essential issues of the scheme. Without those provisions, the text would be inapplicable for most companies.
We need to maintain the proposed advances concerning the limitation on specific sub-sets of assets backing specific liabilities and the deletion of the long-term holding criterion of five years. Concerning the liquidity constraint, we identified two possible path forwards. On the one hand,

the duration and liquidity buffer should be improved. To this regard, we note that discounting the duration at a flat zero rate would be fully justified and the liquidity buffer should consider cash outflows over five years at most. On the other hand, liquidity tests should be defined in a clear and operationally sound manner. Finally, we underline the fact that equities backing own funds should be eligible to the LTEI reduced capital charge as own funds are very suitable for investing in very long-term assets but do not benefit from the buffering effect of profit sharing in life insurance for the calculation of the SCR. However, the eligibility criteria should be carefully verified in non-life undertakings.

**Sustainability, climate change**

The increasing frequency and severity of natural catastrophes linked to climate change are affecting insurance undertakings. Through insurers' roles as investors, underwriters and risk managers, the sector also has an important role to play in climate risk mitigation and the transition during the climate change. The extensions of the Solvency II framework proposed by EIOPA and the Commission seem to be a suitable way to emphasise the importance of this issue. It can help to harmonise the overall treatment. An amendment of the framework in this regard should respect the principles-based character of Solvency II. Regarding other sustainability issues, an overlapping with Corporate Sustainability Reporting Directive (CSRD) should be avoided.

If an undertaking is materially exposed to climate change risks these risks must be analysed in its ORSA. The potential impact of climate change risk on an insurer's solvency position is not limited to short-term effects. Long-term considerations and transition risks must be considered as well. Meaningful long-term scenarios should incorporate available results published in scientific reports. EIOPA should provide further guidance for companies with limited expertise in this area.

The AAE supports EIOPA's conclusion that the SCR for natural catastrophe underwriting risk should be regularly updated to reflect the expected impact of climate change with the aim to ensure continuing policyholder protection and stability of the insurance market.