REVIEW OF THE SOLVENCY II (SII) DIRECTIVE: STATE OF PLAY

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The approval of the Solvency II directive marks a crucial step towards a new supervisory framework. It contains numerous empowerments for the EU Commission to lay down fundamental specifications in delegated regulations and technical standards. In September 2021, the Commission had announced[1] consideration of EIOPA's advice and legislators have added some additional requirements to provide further guidance in this regard. This has allowed a preliminary assessment of the potential outcome.

Besides the mandatory review required by Article 77(f), the directive is extended to consider sustainability, climate change and macroprudential risks. A reduction of the solvency capital requirement (SCR) allows the support of European projects and the Green Deal. Additionally, addressing the issue of proportionality could relieve undue burden from smaller undertakings.

'The review of the directive results in methodological changes results in methodological changes of extrapolation and volatility adjustment of liquidity risks'

The review of the directive results in methodological changes regarding the extrapolation of the Risk-free Interest Rate term structure (RFR) in Article 77(a) and the volatility adjustment (VA) in Article 77(d).

Regarding extrapolation, the new methodology based on a formula and a parameter for the convergence speed, replaces for the euro the explicitly prescribed convergence process towards the ultimate forward rate (UFR). The starting value and speed parameter determine the impact on the UFR. The weight of the UFR 40 years past the starting point shall be at least 77.5%.

With regard to the formula proposed by EIOPA, this prescribed weight requires a lower bound of at least 11% for the speed parameter applied in the convergence process, slightly above the 10% proposed by EIOPA. Two impact assessments performed by EIOPA in 2019 and 2020 proved the limited capability of this method to mitigate short-term market turmoil. >

[1] Communication from the commission to the European Parliament and The Council on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recovery, COM(2021) 580 final, Brussels, 22.9.2021

A phasing-in mechanism which runs until 2032 is provided in Article 77(a) to mitigate the impact of the introduction of this requirement.

The VA shall reflect the fact that insurers are not forced to react on daily spread changes. It can help to reduce volatility by allowing an adjustment to the RFR in this regard. Spreads will still be determined from the currency-specific reference portfolio as the difference of the yield earned from included bonds to the basic RFR. A risk correction (RC) aims at eliminating risks inherent in these spreads. Currently the RC is based on the Long-term Average Spread (LTAS), determined over a period of 30 years. For corporate bonds, the risk of default and the cost of downgrade are taken into consideration. The VA amounts to 65% of this risk corrected spread. This static RC does not react on sudden spread increases and can result in an overly high VA. Applying a VA not justified by undertakings' own assets can cause an underestimation of technical provisions. This is referred to as overshooting risk.

'Applying a VA not justified by undertakings' own assets can cause an underestimation of technical provisions'

The proposed determination of the RC as a percentage of the spread is more risk sensitive. To mitigate the effect of daily changes, this percentage shall decrease if the spread increases. The RC shall never exceed an 'appropriate' percentage of the LTAS. An undertaking-specific credit spread sensitivity ratio (CSSR) shall reflect the different sensitivities to spread changes of own assets and liabilities to limit the risk of overshooting. The VA is calculated as 85% of the risk-corrected spread, multiplied by CSSR. Besides these quantitative requirements, the significance of deviation of own-risk profile from the assumptions underlying the VA shall be assessed within the ORSA and risk management in general. In particular, the VA shall be considered in Liquidity Risk Management Plans (LRMP). It is noted that only internal model users can use the dynamic VA.

The interest rate risk module shall consider an appropriate stress even in a low-interest or negative interest environment. Deviating from the current treatment the stress parameters shall only be applied to the liquid part of the RFR. This stressed part shall be extrapolated like the basic RFR. A 'negative floor' shall be determined in such a way that the likelihood of interest rates falling below is sufficiently small.

The preferred treatment of a sub-set of equity investments as long-term equity investment shall strengthen insurers' role as long-term investors. The conditions concerning eligibility of equities and administration of this asset class are adapted and now included as a new Article 105(a) in the directive. The stress parameter for this class is set at 22%.

A significant reduction in required capital will result from the modified calculation of the risk margin. The risk margin is determined as the product of a Cost of Capital (CoC) rate and the present value of projected SCRs. The CoC-rate will be reduced from 6% to 4.75% and it is expected to vary between 4% and 5% if a future review proves the need for an amendment. The present value of future SCRs shall be adjusted by an exponential and time-dependent element as proposed by EIOPA in its lambda approach. An appropriate lambda and a possible floor should be determined in delegated regulation.

Proportionality is considered by increased thresholds which allow exempting insures from the use of SII. The new category of small and non-complex undertakings (SNCU) is included. These can automatically make use of a list of proportionality measures and simplifications. >

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The framework is extended by macroprudential tools. Significant importance is placed on the management of liquidity risks. Liquidity risk management plans (LRMP) are expected to ensure a sufficient capacity to handle financial obligations to policyholders even under stress scenarios. The content and frequency of updates of the LRMP shall be specified in regulatory technical standards.

Undertakings (except SNCUs) which are materially exposed to climate change risk must assess the impact on their business through the ORSA by specifying and considering at least two long-term climate change scenarios with a prescribed temperature increase of up to 2 degrees Celsius and one with a significantly higher increase.

‘Significant importance is placed on the management of liquidity risks’

Transition plans shall be developed and disclosed to document that undertakings are supporting the objectives of the Green Deal. The calibration of the natural catastrophe sub-module shall be reviewed at regular intervals. EIOPA has launched a proposal for the recalibration of this module in April this year and is seeking input from stakeholders through a public consultation.

Overall, the scope of the microprudential framework is widened by consideration of macroprudential tools. While policyholder protection is still an important objective, political goals have gained in importance. The principles-based character is affected by more rules and prescriptive elements. Despite the additional guidance included in the directive, the capability to mitigate short-term market

turmoil or to prevent procyclical behaviour can be reduced compared to the current regulation. It is expected that the administrative burden would increase by the inclusion of macroprudential and sustainability issues.

In today’s economic environment, insurers’ solvency is not expected to be affected negatively and may possibly benefit from a reduction in capital requirements in certain cases. However, this will not reach €100 bn, as initially expected by the Commission. <