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Revised Solvency II Directive

The AAE shares initial perspectives with respect to the review of Solvency II

Introduction

Solvency II has proven its effectiveness as a robust risk-based framework, ensuring policyholder protection and financial stability across Europe, even during periods of historically low interest rates and the recent pandemic. Insolvency among insurers has remained a rare occurrence within the EU. However, regular reviews of the framework are essential to address the need for recalibration of risk parameters or models, incorporation of new risks, and alignment with evolving political priorities.

The revised Solvency II Directive (SII) not only reflects the outcomes of the mandatory review of long-term guarantee (LTG) measures but also integrates considerations of sustainability and macroeconomic factors. The capital relief for insurers, proposed in the revised Solvency II framework, aims to advance other important policy objectives, such as reducing the protection gap, supporting the EU Green Deal and Capital Markets Union initiatives, and enabling sustainable long-term business models for the insurance sector, all while maintaining policyholder protection. Furthermore, capital requirements must be evidence-based and appropriately risk-sensitive. A principles-based framework, with an enhanced role for key functions in risk management, is best suited to achieve these goals.

The directive assigns the final determination of critical issues to the European Commission, which could significantly impact the amended SII framework. The Commission's announcement that they will consider the advice of the European Insurance and Occupational Pensions Authority (EIOPA) allows for a first assessment of possible recommendations that could be made with regard to follow-up guidance.

It is noted that, although the revised SII Directive has been agreed, the new directive will be complemented by *Level 2* legislation comprising of the *Delegated Acts* and *Implementation Acts* as well as *Level 3 Guidance and Standards*. These subsequent texts can have a significant impact on the Solvency II framework in terms of its application and resulting capital requirements.

Therefore, although this document shares our preliminary views on the revised SII Directive, we expect that there will be a need to follow up with additional reviews, to support EIOPA and the European Commission in the technical aspects of Level 2 and 3 texts where the actuarial profession can act as valuable resource for technical advice and expertise.

The Actuarial Association of Europe (AAE) is prepared to actively contribute its technical expertise to assist policymakers in drafting detailed legislation and supervisory texts.

The Actuarial Association of Europe (AAE) was established in 1978 under the name Groupe Consultatif to represent actuarial associations in Europe. Its primary purpose is to provide advice and opinions to the various organisations of the European Union - the Commission, the Council of Ministers, the European Parliament, the European Supervisors and their committees – on actuarial issues in European legislation. The AAE currently has 38 member associations in 37 European countries, representing nearly 30,000 actuaries. Advice and comments provided by the AAE on behalf of the European actuarial profession are totally independent of industry interests.

The Actuarial Association of Europe is registered in the EU Transparency Register under number 550855911144-54

This document shares our initial views with respect to the following topics:

1. Extrapolation of risk-free rate curves,
2. Volatility Adjustment,
3. Risk Margin,
4. Interest rate risk sub-module,
5. Long-term Equity Investment,
6. Sustainability & Climate Change, and
7. Liquidity risk.

1. Extrapolation of risk-free rate curves

Extrapolation of risk-free rate curves refers to the method used to extend the risk-free interest rates beyond the maturities for which data from deep, liquid and transparent markets are available. Under Solvency II, the starting point of the extrapolation and the methodology used for extrapolation of these curves is crucial because insurers often have obligations that extend far beyond the maturities for which liquid and observable market rates are available.

We recognise the efforts to mitigate the impact of the revised extrapolation methodology. The mandated minimum weight of 77.5% for the Ultimate Forward Rate (UFR) for maturities extending at least 40 years beyond the first smoothing point establishes a lower bound for the convergence speed parameter Alpha at 11%, slightly higher than the proposed 10% in EIOPA's technical advice.

In a low interest rate environment, this adjustment could still result in a significant increase in the Solvency Capital Requirement (SCR). Legislators appear to be aware of the reduced ability to buffer short-term market volatility. Notably, EIOPA's impact assessments conducted in 2019 and 2020 led to the inclusion of a phasing-in mechanism for extrapolation under Article 77a, extending until 2032. Article 308f outlines potential phasing-in processes that may be required concurrently, which could pose substantial administrative challenges.

The extrapolation method should be flexible enough to adapt to changing financial developments, including the unprecedented prolonged low and negative interest rate environment, and should work without the phasing-in mechanism when it is implemented.

Key Message

To limit the risk of disruptions at the time of implementation, we advocate for selecting an Alpha value above the minimum threshold. This mechanism would thereby only be utilised in the event of significantly lower interest rates.

Regarding the determination of the First Smoothing Point (FSP), we note that a sufficiently high percentage of outstanding bonds with the same or longer maturity should be decisive in choosing the starting point. In particular, the residual volume criterion should not be less than 6% to provide stability in the extrapolation for undertakings with long-term liabilities.

2. Volatility Adjustment

The Volatility Adjustment (VA) is a mechanism within the Solvency II framework designed to mitigate the impact of daily spread changes on insurers' balance sheets. It can be used to adjust the risk-free interest rate term structure used to calculate the best estimate liability, aiming to reduce pro-cyclical investment behaviour. The relevant spreads are derived from currency-specific reference portfolios. A risk correction shall eliminate the risk of default or the cost of downgrade. Currently, this risk

correction is static and based on the Long-Term Average Spread (LTAS). The VA is calculated as 65% of the resulting risk-corrected spread.

The new formula for calculating the VA aims to enhance risk sensitivity. Applying an excessive VA, which is not justified by an undertaking's own assets, can lead to an underestimation of the technical provisions. To mitigate this risk, the Credit Spread Sensitivity Ratio (CSSR) has been introduced to reflect any duration gap between assets and liabilities. Additionally, a basis risk correction, subject to supervisory approval, has been implemented.

The risk correction as a percentage of the observed spread can increase the likelihood of pro-cyclical activities. According to Article 77d, the guidance for the Risk Correction (RC) now requires that the percentage of the spread decreases when spreads increase, resulting in a lower contribution to the VA under stressed conditions. Three levels of spread relative to the LTAS must be explicitly considered, ensuring that an appropriate percentage of the LTAS is not exceeded. Alongside the increased application ratio of 85%, the resulting VA may be higher than with the current methodology.

It seems that despite the refinement of the formula, several limits of the methodology remain – i.e., there is reliance on the currency-specific reference portfolio, which may significantly differ from an undertaking's own assets. Moreover, the portfolio is updated only once a year.

As such, the inherent risk in the use of the VA is not fundamentally changed and the economic risk is not adequately addressed. Therefore, despite the increased complexity of the formula with the intention of enhanced risk management, it is still necessary to consider the impact of the VA in the Own Risk and Solvency Assessment (ORSA).

Key Message

In conclusion, relying solely on a rule to prevent overshooting is insufficient. Achieving this goal requires the continuous involvement of risk management, as is the case today. Taking this into account, the specifications of the CSSR, as well as the content and frequency of the required liquidity risk management plans, should aim to minimise the burden on undertakings.

3. Risk margin

The risk margin is an additional buffer included in the calculation of technical provisions under SII and represents the cost of holding capital to support insurance liabilities over their lifetime, incorporating the element that if an insurer were to transfer its liabilities to another entity, the receiving entity would be adequately compensated for assuming those liabilities. As such, the risk margin is an important component of the technical provisions and has a direct impact on insurance company's own funds.

Key Message

We welcome the approach to reduce the impact of the projected SCR on the risk margin through the proposed lambda approach. Moreover, we recognise that the cost-of-capital rate of 4.75% has been set based on regulatory and policy considerations.

The proposed revision could result in a significant reduction in the risk margin and therefore a reduction in capital requirements. It is important to strike a balance between reducing capital requirements and ensuring the continued protection of policyholders.

The AAE will continue to monitor the developments and any proposed adjustments to the methodology pertaining to the risk margin.

4. Interest rate risk submodule

The interest rate risk submodule is a critical component of the Solvency II framework, designed to assess the impact of changes in interest rates on an insurer's balance sheet. It evaluates the sensitivity of assets and liabilities to interest rate fluctuations, ensuring that insurers hold sufficient capital to mitigate potential losses arising from adverse interest rate movements. This submodule is vital for maintaining the financial stability and solvency of insurance companies, particularly in volatile economic environments.

The evolution of interest rates since EIOPA's final opinion in 2019 has raised concerns about the appropriateness of the proposed calibration. While the calibration focused on the risk of decreasing interest rates, it has proven insufficient for addressing the risk of increasing rates.

Key Message

A reassessment of the methodology should ensure appropriate treatment of different yield curve types, including normal, inverse, and flat curves. We propose considering Level 2 amendments to further discuss comprehensive risk assessments under various economic conditions, such as low and high-interest rate environments and high inflationary scenarios. Additionally, the impact of UK data needs to be re-evaluated.

5. Long-term equity investment

The long-term equity investment framework under SII is designed to encourage insurers to invest in equities over a longer term, thereby providing stability to the financial markets and enhancing the role of insurers as significant institutional investors. This framework recognises the long-term nature of many insurance liabilities and aims to align the investment horizon of insurers with their liability profiles. It is important for accommodating long-term investments, supporting economic growth, and ensuring that insurers can meet their obligations to policyholders while maintaining financial stability.

To strengthen the role of insurers as investors, the Commission aims to remove regulatory obstacles while maintaining financial stability and policyholder protection. We welcome the initial steps outlined in Article 105a. The implementation at Level 2 should ensure that this framework achieves its intended objectives with an appropriate setup.

Key Message

In terms of application at the fund level, we note that the requirements should not be more stringent than the current framework defined in the 2018 review. Additionally, we understand that the Directive's stipulation that *"the insurance or reinsurance undertaking is able to demonstrate to the satisfaction of the supervisory authority that on an ongoing basis and under stressed conditions, it is able to avoid forced selling of equity investments within the sub-set for five years"* suggests some form of liquidity test. It is important to ensure that the approach to be adopted does not rely solely on crude ratios and that it captures the various liquidity constraints in order to provide a fair and accurate assessment of risks.

We would like to emphasise that setting a threshold for the maximum amount of equity eligible for long-term investment based on "averages" or "best estimates" may overlook the diverse situations of insurance undertakings. Consideration should be given to the different characteristics of portfolios, where life and non-life insurers may hold significantly different amounts of equity allocations.

6. Sustainability & Climate Change

We consider the extensions of the Solvency II framework to be a suitable approach for emphasising the importance of harmonising the overall treatment of these issues. Any amendments to the framework should respect its principles-based nature and avoid being overly prescriptive. This approach ensures that the framework remains flexible and adaptable to the evolving nature of the insurance industry and the broader financial landscape.

Key Message

Regarding risk management requirements related to sustainability issues, we support the inclusion of sustainability risks in the Own Risk and Solvency Assessment. However, it is crucial to avoid overlaps with the Corporate Sustainability Reporting Directive to prevent redundancy and ensure clarity in reporting obligations. This distinction will help insurers manage their sustainability risks more effectively while maintaining compliance with both Solvency II and CSRD requirements.

We welcome the review of parameters that have essentially remained unchanged since 2010, despite some discussions in 2018. Parameters affected by climate change should be prioritised. Climate change poses significant and evolving risks, and updating these parameters will help insurers better assess and manage these risks.

The AAE will closely monitor this process to ensure the appropriateness of the risk assessment. In the meantime, we would like to refer to our recent contribution to EIOPA's consultation on the Prudential Treatment of Sustainability Risks which can be found on the [AAE website](#) and provides detailed comments with respect to the inclusion of such risks in capital models.

7. Liquidity risk

The amended SII directive introduces Article 144a, which mandates that insurers develop a comprehensive liquidity risk management plan. This plan should include detailed analysis and indicators to effectively monitor liquidity risk. Additionally, Article 144b grants supervisors new powers to oversee potential liquidity risks.

Key Message

We believe it is crucial to assess potential liquidity risk using a full balance sheet approach under various stress scenarios, such as those included in the ORSA report. The adopted approach should ensure that all aspects of liquidity risk are thoroughly evaluated, with the aim of improving the undertaking's risk management framework.

Finally, all further specifications in Regulatory Technical Standards or guidelines should appropriately reflect the unique characteristics of the insurance business with a primary focus on policyholder protection, while ensuring proportionality for smaller insurers.

The AAE would be happy to share its experience in this regard and to provide support.