SOLVENCY II 2020 REVIEW: A SEEMINGLY ENDLESS STORY APPROACHING ITS END

BY **SIEGBERT BALDAUF**

The amended Solvency II Directive entered into force on 28 January 2025, simultaneously with the Insurance Recovery and Resolution Directive (IRRD). It was a decision of the Commission to consider recovery and resolution in a separate Directive which shall be fully consistent with Solvency II. After transposition to national law, both will become applicable from 30 January 2027. To become fully operational further specification in Delegated Regulation, Regulatory or Implementing Technical Standards or in Guidelines is required.

SOLVENCY II: EXTENSION OF SCOPE AND SUPERVISION

The outcome of the Solvency II Review will implicate changes in the regulatory regime. The IRRD requires the establishment of resolution authorities in each member state which shall closely cooperate with the supervisor. Drawing up of pre-emptive recovery plans, communication with resolution authority will become a new responsibility for the risk management of certain companies.

Furthermore, macroeconomic and financial market developments shall be incorporated into undertakings' own risk and solvency assessment (ORSA). Supervisory authorities are required to communicate the results of these macroprudential assessments to **bodies or authorities with a macroprudential mandate** in order to determine the potential impact of undertakings' activities on macroeconomic and financial market conditions.

ABOUT THE AMENDMENTS

When assessing the outcome of the review, it is important to compare it with the initial objectives. The Commission had listed the following aims of the review:

(1) provide incentives for insurers to contribute to long-term sustainable financing of economy and remove obstacles for long-term investments;

(2) improve risk-sensitivity;

(3) mitigate excessive short-term volatility in insurers' solvency positions;

(4) improve proportionality;

(5) better address the potential build-up of systemic risk in the insurance sector;

(6) improve preparedness for extreme scenarios that may make recovery or the resolution of a failing insurer or reinsurer necessary. >

INCENTIVES TO CONTRIBUTE TO LONG-TERM SUSTAINABLE FINANCING OF ECONOMY AND REMOVE OBSTACLES FOR LONG-TERM INVESTMENTS

The amendment of the framework is significantly influenced by political objectives. Commission emphasises the role of insurers as investors with assets of more than 10 trillion Euro under management. To better support the Savings and Investments Union and the European Green Deal, obstacles for long-term investment should be eliminated. Less conservative calibrations can also help to release capital.

Protecting policyholders and beneficiaries, as well as the preservation of financial stability[1] shall nevertheless remain the principal objectives of Solvency II.

Approval of certain investments as 'long-term equity' will become easier. Upon approval by the supervisor, the reduced capital charge of 22% can be applied for such investments. Nevertheless, a thorough risk management is indispensable to ensure that the required holding period of 5 years will not be impaired.

The amended calculation of the risk margin will lead to a significant relief of capital. The reduction of the cost of capital-rate from 6% to 4.75% will already reduce the risk margin by about 21%. Politics expect a channelling of the freed capital towards productive investments in the real economy. The modification of the calculation formula by introduction of a new element (lambda – approach) will in addition decrease the amount of the risk margin especially for long-term business. This amendment will also reduce the sensitivity to changes of the interest rate.

Improve Proportionality: Higher thresholds for exemptions from Solvency II requirements based on size, along with the introduction of a new category for small and non-complex undertakings (SNCUs), are intended to increase proportionality. A list of proportionality measures unconditionally available for SNCUs can lower considerably the administrative burden. Upon prior approval by the supervisor, non-SNCUs can benefit as well from some of these measures. The criteria to be considered are defined specific for each of the eligible measures in a new chapter on proportionality measures of the delegated regulation.

Macroprudential tools introduced in the Directive require to assess activities that have the potential to turn into sources of systemic risk in undertakings' ORSA. Liquidity risk is assessed as a risk of particular importance. Supervisors are granted far reaching intervention powers in the articles 144b and 144c of the Directive. Further macroprudential analyses shall be considered and analysed in the ORSA upon request of the supervisor.

Improvement of the risk-sensitivity shall be achieved by a new methodology for the extrapolation of the risk-free interest rate term (RFR) structure and for the calculation of the volatility adjustment (VA). An improved risk-sensitivity goes along with a higher volatility in the solvency positions of undertakings. Striking a balance between these conflicting effects is of special importance for the valuation of long-tern business. Although guidance to limit this volatility is included in the Directive for both measures, the capability to mitigate excessive short-term volatility depends on the specification in the delegated regulation. The now proposed changes have the potential to provoke artificial volatility in insurers' solvency position.

Sustainability: While Article 45a of the Directive requires already the analysis of material climate change risk in the ORSA, the management of sustainability risk management is not yet concretised. Commission has recently decided >

[1] Communication from the Commission to the European Parliament and the Council COM(2021) 580 final Brussels, 22.9.2021

to postpone the finalisation of the Regulatory Technical Standard referring to this until October 2027. Preliminary requirements for a disclosure in the SFCR are already laid down in the new article 297a of the Delegated Regulation.

Interest rate risk: The recalibration of the interest rate down risk now remedies a shortcoming of the current framework which does not require the application of a stress parameter for negative interest rates. The introduction of a maturity dependent floor below which negative interest rates cannot fall helps to mitigate excessive effects. The defined stress shall now be applied only to the liquid part of the RFR. This stressed part shall be extrapolated consistently with the extrapolation of the relevant RFR.

ASSESSMENT OF THE OUTCOME

Regarding the above-mentioned objectives the outcome of the review shows a heterogeneous picture. Proportionality is significantly improved. The IRRD can facilitate the treatment of failing insurers. The consideration of macroeconomic risk in the ORSA can help to recognize the building-up of systemic risk.

The regulation concerning long-term investments shows a mixed picture. The political objectives targeting insurers role as investors are reflected by a detailed treatment of long-term equity. The regulation concerning extrapolation and the VA with improved risk-sensitivity will reduce the capability to mitigate excessive short-term volatility in insurer's solvency position.

Political compromises during the review process have increased complexity. More rules and higher reporting requirements followed especially from the consideration of sustainability issues.

It remains important, to preserve the principles- and evidence-based character of Solvency II. Professional judgement is indispensable to live up to such a regulation. This is especially true for users of the standard formula. Even if reduction of conservatism in the calibration of risk parameters can be substantiated by market observations, it is necessary to analyse to which extent this is appropriate for the individual undertaking. A possible relief of capital can reduce resilience of an undertaking. Policyholder protection, the ability to meet at any time the obligations resulting from insurance contracts must not be impaired. An effective risk management is essential in this regard. **<**

SIEGBERT BALDAUF CERA is an independent actuary, and works as Chair of the Solvency II Working Group for AAE.