Solvency II Review

How does EIOPA's advice support long-term investing by the insurance industry?

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Almost two years since the formal commencement of the Solvency II Review, EIOPA's Opinion on the Solvency II Review published on 17 December 2020 marks the latest milestone as the EU moves towards unveiling its proposals to revise Solvency II, currently expected to land in Q3 2021.

The scope of the review is broad, with the European Commission's letter to EIOPA requesting advice on areas spanning long-term guarantees, risk margin and the standard formula to group supervision, reporting, proportionality and macroprudential risk. The final Opinion by EIOPA, accompanied by over 1000 pages of technical analysis, builds on numerous stakeholder consultations, including the Holistic Impact Assessment launched in February 2020.

While it is easy to get lost in the technicalities of Solvency II, the context in which the Solvency II review takes place and how the Solvency II Review fits in with wider EU policy priorities are important to consider. The EU's Green Deal, the Digital transformation and its pursuit of strategic autonomy are key drivers of EU policymaking. We therefore find it interesting that issues relating to sustainability, but also cyber resilience, are notably absent from EIOPA's advice.

More specifically, the European Commission stated in its recent inception impact assessment for the Solvency II Review that it would look to focus on the following five objectives:
- **Enhancing the ability of the insurance industry to financing the economy, in particular the economic recovery from COVID-19, by mitigating the impact of short-term market volatility on the solvency position of insurers and facilitating the provision of long-term guaranteed products while taking into account the low interest rate environment;**
- Improving the proportionality of the framework to reduce the regulatory burden on smaller firms;
- Strengthening the internal market for insurance by improving supervisory convergence and enhancing policyholder protection;
- Preventing the build-up of systemic risks and ensuring financial stability;
- Ensuring that the framework provides incentivises to address sustainability, in particularly climate change, in insurers' investment and underwriting activities.

In this note, we will explore in particular how EIOPA's advice delivers against the stated ambition to build a Capital Markets Union and the role that the insurance industry plays in financing the economy. We conclude that EIOPA's advice remains rather timid when it comes to making any significant changes to Solvency II when it comes to long-term investments and liabilities, we expect the current political and economic backdrop to act as a significant tailwind to alleviating some of the more onerous requirements to enable the insurance industry to fuel the economic recovery.

In a press release issued on the day that EIOPA published its advice, Insurance Europe conclude that

"EIOPA's Solvency II review opinion fails to offer improvements to help EU economy, consumers and green transformation"

Key Features of EIOPA's advice

01
Long term guarantee measures and equity risk

- Change the method of extrapolating risk-free interest rates to better reflect market rates
- Volatility adjustment: better align the design if the adjustment to its objectives, in particular reward insurers for holding illiquid liabilities
- Risk margin: recognise diversification over time thereby reducing size and volatility of the margin, especially for long-term liabilities
- Equity risk: revise the criteria for the ability to hold equity long-term, by making a link with long-term illiquid liabilities

02
Solvency capital requirements

- Increase the capital requirement for the interest rate to reflect the steep fall of interest rates experienced during the last years and the existence of negative interest rates

03
Proportionality

- Increase proportionality across the three pillars of Solvency II, especially regarding low risk undertakings
- Introduce a new process for applying and supervising the principle of proportionality characterised by clarity, predictability, risk sensitiveness, supervisory dialogue and reversal of the burden of proof
- Increase the effectiveness of proportionality embedded in the supervisory review process
- Increase the transparency on the use of proportionality measures across the three pillars of Solvency II

04
Macroprudential policy

- Supplement the current mircoprudential framework with a mircoprudential perspective
- Introduce tools and measures to equip national supervisory authorities with suggicient powers to address all sources of systemic risk

05
Recovery and resolution

- Develop a minimum harmonised and comprehensive recovery and resolution framework for (re) insurers to deliver increased policyholder protection and financial stability in the European Union

06
Insurance guarantee schemes

- Introduce a European network of national insurance guarantee schemes or alternative mechanisms that should meet a minimum set of harmonised features for the benefit of policyholders and financial stability

Source EIOPA, December 2020

Timeline

2021

Q3 2021
European Commission proposal on the review

December
Final advice submitted to EC and published

July to September 2020
Complementary information request to take into account impact of Covid-19 pandemic

2020

March to June
Information request to undertakings for holistic impact assessment

Mid-October to January 2020
Public consultation on draft advice (on all advice other than on reporting & disclosure and insurance guarantee schemes)

2019

Mid-July to mid-October
Public consultation on draft advice on reporting & disclosure and on insurance guarantee schemes

February
EIOPA receives a call for advice on the 2020 review from the European Commission

Capital Markets Union and the role of insurance

The Capital Markets Union the EU's plan to create a truly single market for capital across the EU. It aims to get investment and savings flowing across all Member States, benefitting citizens, investors and companies, regardless of where they are located. The Capital Markets Union is essential for delivering on all of the EU's key economic policy objectives: post-COVID-19 recovery, an inclusive and resilient economy that works for all, the transition towards a digital and sustainable economy, and strategically-open autonomy in an increasingly complex global economic context. Meeting these objectives requires massive investment that public money and traditional funding through bank lending alone cannot deliver. The Capital Markets Union has become more urgent in light of the crisis induced by COVID-19.

The role of the insurance industry as a long-term investor was highlighted as part of the Capital Markets Union, with the Solvency II Review as the main conduit to affect change in support of this goal. In its Action Plan, the European Commission committed to "assess the appropriateness of the eligibility criteria for the long-term equity asset class, the risk margin calculation, and the valuation of insurers' liabilities, with the aim of both avoiding undue pro-cyclical behaviours and better reflecting the long-term nature of the insurance business".

This follows on from the European Commission's letter requesting advice on Solvency II, which called on EIOPA to consider the Capital Markets Union aspects of Solvency II and its treatment of longer-term investments. More specifically, EIOPA was asked to: "assess whether the methods, assumptions and standard parameters underlying the calculation of the market risk module with the standard formula appropriately reflect the long-term nature of the insurance business, in particular equity risk and spread risk."

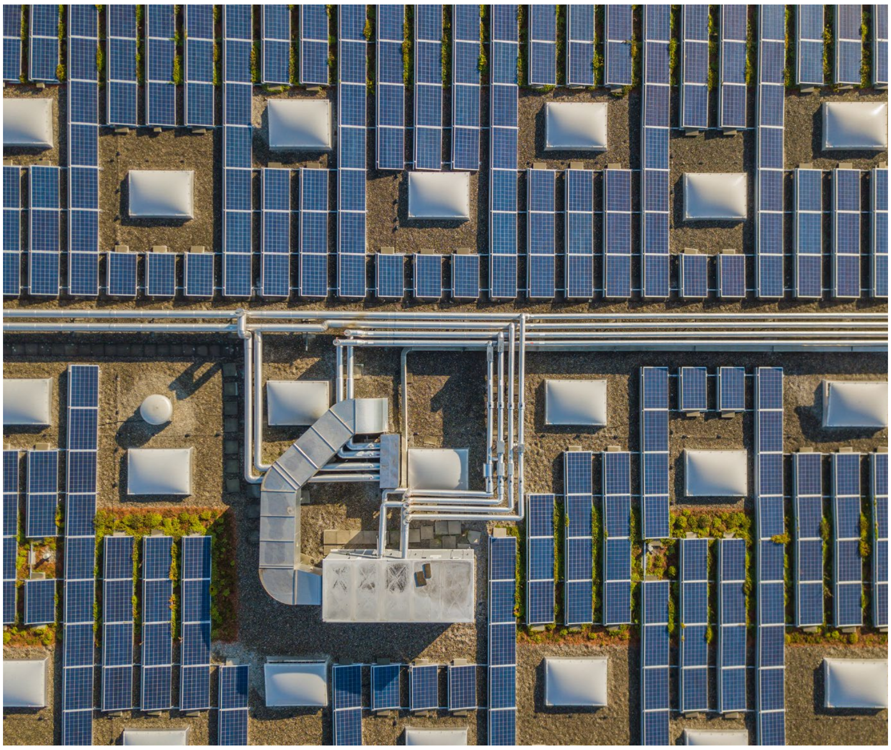
More broadly, the measures for long-term guarantees are highly relevant here. These measures are widely used by the insurance industry in Europe – in its 2020 annual report on the use of LTG measures, EIOPA found that 80% of undertakings make use of at least one of the following:

- The matching adjustment
- The volatility adjustment
- The transitional measures on the risk-free interest rates
- The transitional measures on technical provisions
- The duration-based equity risk sub-module

For the undertakings using these measures, removing the measures would result, on average, in a reduction to the Solvency Capital Requirement ratio of 43 percentage points.

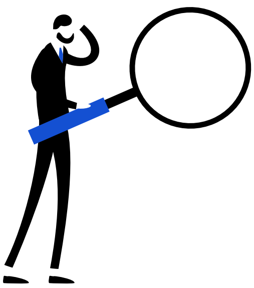
In seeking to examine the impact of EIOPA's advice on long-term investment, we will examine provisions that are seen as driving insurers behaviour in this space:

- **Measures that affect the valuation of liabilities, in particular long-term liabilities:** the extrapolation method, the matching adjustment, the volatility adjustment and the risk margin
- **Measures that affect the capital treatment of long-term investment:** the long-term equity risk charge, spread risk, and the volatility adjustment



Valuing long-term liabilities

Insurance undertakings have the capacity to make long-term investments due to the long-term nature of their liabilities. However, a frequent criticism of Solvency II is that, by using market-consistent rates, the regulation disincentivises long-term guarantee products. To assess the extent to which EIOPA's advice might address some of these flaws, we will focus on the following four measures: the extrapolation method, the matching adjustment, the volatility adjustment and the risk margin.



Taken together the package of measures would reduce capital surplus by between

20-45bn EUR

1. Extrapolation method

The market consistent valuation principle is fundamental to Solvency II, whereby undertakings must value their liabilities using discount rates implied by market-based risk-free interest rates. However, beyond a certain point (the "last liquid point") the specification of the risk-free interest rate structure is based on an extrapolation to an "ultimate forward rate". With continued low long-term interest rates, pressure has been mounting to more review the extrapolation method, with potential consequences for insurance undertakings with long duration liabilities.

EIOPA proposes to change the method to **extrapolate risk-free interest rates** in order to take into account market rates beyond the starting point of the extrapolation, replacing the Last Liquid Point with the First Smoothing Point. EIOPA claims this will help to avoid underestimation of technical provisions for insurance liabilities and setting wrong risk management incentives, however, it is also likely to make long-term duration liabilities more expensive.

2. Matching adjustment

The matching adjustment allows firms to adjust the relevant risk-free interest rate term structure where its long-term liabilities are matched with long-term cash flows.

Here, EIOPA has introduced limited changes. The proposal aims to recognise in the Solvency Capital Requirement standard formula diversification effects with regard to **matching adjustment portfolios**. Further specifications are also proposed when including restructured assets within the matching adjustment.

3. Volatility adjustment

The volatility adjustment is a measure to ensure the appropriate treatment of insurance products with long-term guarantees under Solvency II. (Re)insurers are allowed to adjust the risk-free rate to mitigate the effect of short-term volatility of bond spreads on their solvency position.

Several changes to the design of the **volatility adjustment** are advised to better align it with the objectives of the adjustment. For this purpose, the adjustment should be split into a permanent and a macroeconomic part. The macroeconomic adjustment should be based on an improvement of the current country-specific increase to mitigate cliff-edge effects in its activation. Application ratios should be applied to the adjustment in order to mitigate overshooting effects and to recognise the illiquidity characteristics of the liabilities of the undertaking. The determination of the risk correction to the volatility adjustment should be modified in order to capture all risk inherent in bond spreads.

4. Risk margin

Risk margin represents the potential costs of transferring insurance obligations to a third party should an insurer fail. Insurance Europe claims that it "currently reduces the risk-taking capacity of the industry by up to €190bn".

A change to the calculation of the **risk margin** of technical provisions is proposed in order to account for the time dependency of risks and thereby reducing the sensitivity of the margin to interest rate changes. The change will reduce the amount of the risk margin in particular for long-term liabilities.

Taken together, the changes proposed by EIOPA are likely to be slightly negative for undertakings' SCR ratios.

While the changes to the volatility adjustment and the risk margin, in particular, are likely to be net positive when it comes to valuing long-term liabilities, the changes to the extrapolation method could counterweigh these benefits. As part of its impact assessment, EIOPA gathered data on the impact of these changes as part of its Holistic Impact Assessment (HIA) and Complementary Information Request (CIR), which found that taken together the package of measures would reduce capital surplus by between 20-45bn EUR.

Summary impact of changes on capital surplus under scenario 1

	Approximate impact on capital surplus	
Changes to	**HIA**	**CIR**
Volatility adjustment	+16 bn	+13 bn
Risk margin	+16 bn	+18 bn
Extrapolation	-34 bn	-61 bn
Correlations	+5 bn	+5 bn
Interest rate risk	-21 bn	-20 bn

EIOPA noted that "[u]ndertakings with long-term liabilities are expected to be more affected by the proposed changes, in particular on extrapolation, risk margin, VA and interest rate risk, than other undertakings".

Capital treatment of long-term investment

When looking at the asset side, we have already seen a number of measures introduced to incentivise long-term investment, including revised calibrations for infrastructure and for long-term equity. Of note here are EIOPA's proposals on spread risk and the long-term equity risk sub-module.

1. Spread risk

The calibration of spread risk was identified by the European Commission as a parameter that could impact long-term investment, particularly in fixed income. As part of its analysis, EIOPA explore whether a long-term bond spread risk sub-module should be introduced, to match the long-term equity risk sub-module that was introduced in the 2018 Review of Solvency II.

EIOPA noted that "the aim of introducing a long-term treatment of fixed income assets in the SCR spread risk sub-module would be to support the capital market union (CMU) and the European economy". However, EIOPA expressed doubts as to whether undertakings are dis-incentivised to invest in fixed income assets, considering that the overwhelming majority of undertakings' investments is already allocated to that asset category. Indeed, EIOPA considered that Solvency 2 may in fact be over-incentivising fixed income investments given the allowance of adjustments on the valuation of the best estimate of technical provisions, the relatively mild calibration of the spread risk charges on bonds and loans and, last but not least, the zero spread risk charges on Member States' government bonds. Therefore, EIOPA advises not to modify the existing SCR spread risk sub-module. In EIOPA's view it is unnecessary and even unwarranted to introduce a separate, long-term treatment of insurance and reinsurance undertakings' investments in fixed income assets, beyond the current, long-term calculation of the spread risk charge of assets contained in matching adjustment portfolios.

To add insult to injury, EIOPA also proposed to limit the use of dynamic volatility adjustment for internal model users by introducing an enhanced prudency principle, while those using the standard model are unable to use such a tool. According to Insurance Europe, "applying the dynamic VA is an effective way to address the flaws in the measurement of spread risk and recognise the actual risk exposure when investing in corporate bonds."

2. Long-term equity (LTE) calibration

The long-term equity risk sub-module was introduced by the European Commission during the review of the Solvency II Delegated Regulation that took place in 2018, against the advice of EIOPA. However, the criteria attached to the use of the sub-module, in particular the need to ringfence the assets, has limited the benefits of the new risk category. According to EIOPA's impact assessment, "when taking into account the total equity reported by all participants, the proportion allocated to LTE represents only 0.68%."

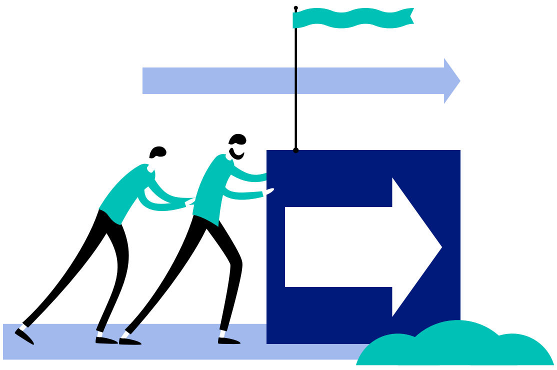
While EIOPA maintains that the reduced risk charge is not corroborate by the evidence, it has nonetheless sought to amend the criteria to better align with the objectives to promote equity investment. In particular, EIOPA analysis found that a key criterion that could increase the use of the LTE category was the extension of the eligibility criteria to life insurance liabilities belonging to Categories I and II under the Volatility Adjustment. EIOPA found that there was a significant increase in the number of undertakings, and in particular the amount of LTE reported when the eligibility criteria was extended (above EUR 26bn, compared with 3.5bn EUR without). The increase mainly arises from life undertakings, in particular in the French market, with a total of 8 life undertakings reporting an amount of EUR 20bn of eligible LTE when the eligibility criteria are extended.

Therefore, the advice includes a review of the capital requirements for **equity risk** and proposals on the criteria for strategic equity investments and long-term equity investments. The criteria for long-term equity investments are made prudentially sound by linking to the illiquidity of long-term liabilities or the introduction of a liquidity buffer. Because of the introduction of the capital requirement on long-term equity investments EIOPA advises that the duration-based equity risk sub-module is phased out.

Conclusion

In publishing its advice, EIOPA announced that its contents represented an "evolution, not revolution" and this is certainly true when it comes to the elements relevant to the Capital Markets Union. While EIOPA's advice may fall short of the more far-reaching changes that the industry may have been hoping for, it's important to remember that EIOPA does not have the final word when it comes to the ultimate outcome of the Solvency II Review. Indeed, some of the existing measures, particularly those pertaining to long-term investments such as the long-term equity and infrastructure risk sub-modules were introduced by the European Commission due to pressure from the European Parliament, in some cases against the advice of EIOPA.

In light of the economic backdrop post-COVID, as well as the European Commission's broader political priorities relating to sustainable economic recovery, the Green Deal and the Digital Transformation, we consider that there is scope for the European Commission to seek to beef up the Capital Markets Union aspects of Solvency II beyond what EIOPA has proposed.



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