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ASSET MANAGEMENT

European Commission's proposal for the review of Solvency 2

Solvency 2

The Commission published its proposal to amend Directive 2009/138, known as the Solvency 2 Directive, on 22 September.

The main objective of this reform is to encourage insurers to increase their long-term contribution to the funding of a sustainable economy and to allow insurance companies with a low-risk profile to qualify for simplified rules. However, new provisions have also been added to better incorporate systemic risks in the insurance sector and other developments aimed at strengthening the quality of supervision and coordination between countries with a view to improving policyholder protection.

Although it reiterates most of EIOPA's December 2020 recommendations, the Commission makes changes that are beneficial for insurers, particularly in the calculation of the risk margin and the volatility adjustment (VA).

Some changes aim to reduce the volatility of the solvency ratio

Expanding the symmetric adjustment corridor for equity charges

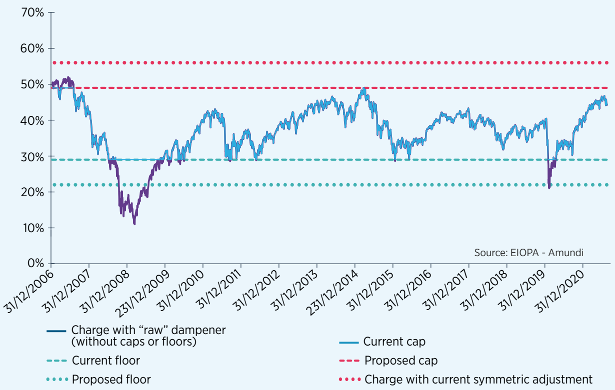
The symmetric adjustment (or equity dampener) aims to be counter-cyclical.

It is calculated using the difference between the level of a composite index[1] observed at the date in question and the index's historical average over the past three years. It therefore mitigates the central equity charge[2] by increasing it in a bullish market and decreasing it after a bearish market. Under current regulations, the symmetric adjustment can vary from -10% to +10%.

The Commission adopts EIOPA's recommendation to increase the effectiveness of the symmetric adjustment by expanding its corridor to [-17%; +17%]. The charge for type 1 equities would thus fluctuate in a corridor of [22%; 56%] instead of [29%; 49%].

The chart shows that in March 2020, the reduction in the equity charge was limited by the current floor and that without limits, the dampener would have taken the equity charge below 22% for a short period. In 2008-2009, the benefit of expanding the corridor would have been much greater, as it would have lowered the equity charge in Q4 2008 and almost all of 2009.

Change in Type 1 equity charge with expanded limits [22% à 56%]



Volatility Adjustment (VA)

The VA is a risk-free yield curve adjustment that can be used to calculate the Best Estimate of liabilities.

It aims to partially offset the impact, on the solvency ratio, of the volatility of the bond portfolio caused by spread volatility.

This part of the long-term guarantees package is widely used. At end-2019, 631 entities in 21 countries, whose technical provisions accounted for 79% of total EEA technical provisions, used the VA[3]. Indeed, unlike the matching adjustment (MA), its use does not require strict asset-liability matching.

1. The index was built to be representative of the investments made by European insurers.
2. 39% for type 1 equities (listed in an EEA or OECD country) and 49% for equities listed in other countries or unlisted equities..
3. Source: EIOPA REPORT ON LONG-TERM GUARANTEES MEASURES AND MEASURES ON EQUITY RISK 2020 – 3 December 2020.

Based on its current definition, the VA is deemed insufficiently responsive and its calculation is not suited to the specific characteristics of the insurers that apply it. It is calculated by currency, and for insurers in an EMU member country, a "country VA" can be added to the "euro VA" under specific stress conditions.

The Commission adopts the principles proposed by EIOPA to improve the system, and in particular the introduction of a factor that account for the duration and/or volume mismatch between fixed-income investments and insurance liabilities of the undertaking. The general application factor is raised from 65% to 85%, thereby increasing the VA's effectiveness, but unlike EIOPA, the Commission does not wish to introduce a factor to account for the illiquidity characteristics of the liabilities.

The VA is always calculated by currency. For the euro, the country component is replaced by a macro-economic component, which is added to the currency component.

VA by currency:

$VA_{Currency} = 85\% * CSSR_{Currency} * RCS_{Currency}$

- The $CSSR_{Currency}$ factor is specific to the insurer. It takes into account the sensitivity of fixed-income investments to credit spreads and the sensitivity of the "best estimate" of liabilities to the VA. It ranges from 0 to 1 and its calculation will be specified in the delegated regulation.

  This factor aims to avoid an insurer benefiting from a high VA (based on the average asset allocation of insurers in the EU) which would have a major impact on its best estimate provisions, while its asset portfolio has little exposure to spread fluctuations (because it contains a smaller proportion of fixed-income assets than the benchmark portfolio and/or its duration is much lower than that of the benchmark portfolio).
- The $RCS_{Currency}$ factor is the risk-adjusted spread of the benchmark portfolio denominated in that currency.

Euro-Macro VA

Calculated by country, the Euro-Macro VA improves on the current country VA.

To take into consideration each country's specific features, the Euro-Macro VA is a function of the difference between the risk-adjusted spread of the portfolio that is representative of the country in question and 1.3x the risk-adjusted spread of the representative global euro portfolio.

It also incorporates a factor $CSSR_{€}$, specific to the insurer, calculated for the euro according to the principle described for $CSSR_{Currency}$ as well as a country coefficient, ranging from 0 to 1, designed to ensure the seamless and gradual activation of the Euro-Macro component. The proposed definition aims in particular to avoid the thresholds effects generated by the current VA calculation.

The use of the new VA is subject to approval by the regulator, but the entities applying the current system will be exempt from this authorisation request.

The changes made to the Pillar 1 provisions should free up capital and encourage long-term equity investments

Interest rate extrapolation method

The Commission uses the method recommended by EIOPA, which relies on smoothing points.

The new approach calls for extrapolating forward rates using a function based on the Ultimate Forward Rate[4] and forward rates calculated over a set of smoothing points corresponding to maturities for which there are market instruments meeting DLT (deep, liquid and transparent market) criteria[5].

Compared to the provisions in force, in current environment of very low euro rates, the proposed extrapolation method leads to a slight decrease in the long end of the curve used to discount liabilities. For this reason, the Commission provides for a transition period ending in 2032. The initial configuration of the function must ensure that there is a very limited impact with the first application, and a gradual transition is called for in order to slowly converge towards the target method.

Calculation of market risk capital requirements

The details of the calculation are not specified in the proposal to amend the Directive because it is covered by the implementing regulation, but EIOPA has recommended several changes.

- **Interest rate risk: an increased capital requirement for many life insurers**

In its December 2020 report, EIOPA presented a new configuration for the stress tests used to assess interest rate risk under the standard formula. EIOPA proposed a new formula for calculating stressed interest rates. The minimum shock of +1% in the upward scenario is removed and negative rates are stressed in the downward scenario. The configuration recommended by EIOPA was presented in the "2020 Review: EIOPA Recommendations" published in January 2021. However, because these elements are covered by Level 2 texts, they are not endorsed by the Commission at this point.

Compared to the current calibration, these changes would increase the amount of capital required for entities with long-term liabilities and a portfolio of assets with significantly lower duration compared to their liabilities. To give insurers the time to adapt gradually, a 5-year transition period is planned to fully apply the new definition of interest rates shocks.

4. The Ultimate Forward Rate has been determined every year since 2017, based on two components, namely the expected real rate and the expected inflation rate, while varying by no more than 15 basis points from year to year. Accordingly, for the euro, the UFR was set at 3.45% for 2022.

5. In 2019, for the euro, the swap maturities meeting the DLT criterion were those of 12 years or less, then 15, 20, 25, 30, 40 and 50 years.

- **Easing of conditions for applying long-term equity investments (LTEI)**

EIOPA has recommended new criteria to define the application framework for the "Long-term equity investments" sub-module. It had recommended replacing the general condition ensuring that the equity sub-portfolio is not subject to forced sales for at least ten years with specific criteria depending on whether the undertaking has life or non-life insurance obligations.

  - For life insurance obligations, LTEI must cover liabilities subject to demonstrated illiquidity and their duration must be longer than 10 years.
  - For non-life insurance obligations, an equity portfolio can be eligible to LTEI only if the insurer also holds high quality liquid assets (HQLAs) that amount to more than the best estimate of liabilities net of reinsurance.

The amount of assets eligible to LTEI could be increased sixfold thanks to this reviewing of application conditions and the insurance sector could more easily contribute to the capital enhancement of European companies (listed or not).

Consideration of sustainability risk

There is no specific configuration at this stage for the calculation of the SCR, but the Commission calls on EIOPA to issue a report

The Commission would like EIOPA to examine whether exposures related to assets or activities predominantly associated with environmental or social objectives warrant a specific prudential treatment.

If the report finds that it is appropriate to differentiate between sustainable and other investments, EIOPA will also need to recommend a more appropriate prudential treatment and assess the impact of the proposed changes on insurance and reinsurance undertakings. The deadline for submitting the report is 28 June 2023.

Mindful of the importance of appropriately taking the risk of natural disasters into consideration, the Commission also calls on EIOPA to review, at least once every 3 years, the calibration of the non-life catastrophe risk sub-module used to calculate the capital requirement under the standard formula.

- **Correlation matrix used to calculate market SCR more favorable for insurers with long-term liabilities**

EIOPA recommends lowering the correlation coefficient between interest rate risk and credit risk from 50% to 25% if the downward scenario prevails. This change is overall positive for life insurers, as their long-term liabilities mean that they most often apply the interest rate down scenario.

In cases where the insurer has to apply the upward scenario, zero correlation between interest rate risk and credit risk is not called into question.

Risk margin: the Commission would like to go beyond EIOPA's recommendations

The Commission plans to lower cost of capital to 5% and apply a factor λ^t to the estimated SCR amount for year T.

Cost of capital was set at 6% in 2014, in an environment of much higher interest rates. In the current environment, it is considered appropriate to reduce this cost. With $\lambda < 1$, the factor λ^t lighten the burden of the most distant risks over time.

In its December report, EIOPA recommended setting a floor of 50% for λ^t, but the Commission is against this recommendation.

In the Commission's view, this set of changes should generally be favourable to insurers. The impact study estimates an increase in the insurance sector's capital surplus of €90 billion with the initial application of these changes.

The gradual implementation (through 2032) of the interest rate provisions should gradually reduce this capital surplus, estimated over the long term at €16 billion (estimates made for economic conditions equivalent to those of mid-2020).

Other changes to the "long-term guarantees package"

Diversification of risks between portfolios that apply the matching adjustment (MA) and the insurer's other activities

At-end 2019, Spanish undertakings were the only left who use the MA. The MA can only be applied to a portfolio of insurance obligations that is managed separately from other activities, and which is assigned a portfolio of assets whose cash flows match those of its liabilities. With the MA, the fixed-income investment rate of return can be taken into account when determining the discount rate applied to the insurance obligations.

Currently, for ring-fenced funds or MA portfolios, the SCR calculation must exclude any risk diversification between these ring-fenced funds or MA portfolios and the rest of the insurance undertaking. The Commission adopts EIOPA's proposal to remove this activities for MA portfolios.

Elimination of the "Long-term equity risk"

This mechanism covers equities held to meet occupational pension obligations.

The insurance undertaking may apply an equity SCR of 22% after receiving approval from its supervisory authority. However, the terms of application of this mechanism are extremely restrictive and it is seldom used (notably, the average duration of the undertaking's liabilities must exceed 12 years).

With the LTEI classification set up in 2019, an equity charge of 22% can be applied. As a result, it is not necessary to maintain the specific mechanism for pension obligations. .

Pillars 2 and 3: The Own Risk and Solvency Assessment (ORSA) is expanded to include climate change risk, the deadlines for certain disclosures are extended and the Solvency and Financial Conditions Report is amended.

Macroeconomic, financial and climate change scenarios

The insurer should take into account macroeconomic scenarios and plausible assumptions of unfavourable financial market trends.

The Commission provides a long list of parameters to be included: changes in interest rates, spreads, market indices, inflation, interconnection with other financial market players, climate change, pandemics and other large-scale events.

Entities with material exposure to climate change risk should regularly assess their solvency in at least 2 long-term scenarios: an increase in temperature of less than 2°C and an increase of more than 2°C.

Insurers should also assess whether or not their business may be a source of systemic risk.

However, the Commission stresses that their assessments should be proportionate to the magnitude and nature of the risks considered and to the complexity of the insurer activities.

Quantitative disclosures and reports to the supervisory authority

The deadline for the annual report is extended to 16 weeks instead of 14, but the deadline for submitting quarterly reports is still very tight (kept at 5 weeks for individual entities). In exceptional circumstances, however (health emergencies, natural disasters, etc.), the Commission can extend these deadlines.

In order to avoid having the insurance sector produce redundant data (i.e. data already provided by other regulated entities), the Commission calls on EIOPA to submit, within 2 years, a report on the measures that need to be taken to organise the sharing of information between national and European supervisory authorities for different categories of entities (banks, insurance companies, asset managers, etc.).

In its recommendations, EIOPA had already discussed two areas where simplifications could be made for insurers: information on derivatives and information in mutual fund transparency. The Commission would like to see these two areas examined as a priority.

The detailed content of the quantitative report is not specified in the Commission document, as it is covered by implementing regulations.

The deadline for submitting the Regular Supervisory Report (RSR) is 18 weeks.

Change in the Solvency and Financial Conditions Report (SFCR)

The Commission adopts EIOPA's proposal to change the form and content of the SFCR. The SFCR is divided into two sections: section one is for policyholders, which should provide an overview of risks, and section two is for professionals, with a structure similar to the current SFCR.

The **policyholder section** should contain summary information on the entity's activity, performances and material risks incurred.

The **professional section** should include a description of the governance system, methods used to measure assets and technical provisions, and MCR/SCR amounts. It should also provide a description of the entity's risk profile and capital management practices.

Furthermore, for entities considered important to the financial stability of the European Union, information on sensitivity to market fluctuations is required.

The second change adopted by the Commission is **the introduction of an auditing requirement for the Solvency 2 balance sheet**. This requirement is applied to entity and group scopes of operation[6], and the auditor's report should be sent to the supervisory authority.

Publication deadlines are extended. The deadline for publication of the SFCR by an individual entity is set at 18 weeks after the end of the financial year.

Multiple provisions extend the principle of proportionality

Higher Solvency 2 exclusion thresholds

The thresholds allowing small insurance companies to be excluded from the scope of the Solvency 2 Directive are raised:

- the threshold on annual premiums is tripled from €5 million to €15 million,
- the threshold on technical provisions is doubled from €25 million to €50 million.

Identification of "Low risk profile" undertakings benefiting from multiple simplifications

The Commission adopts EIOPA 's recommendations for identifying **"Low risk profile"** undertakings.

Undertaking that believe they meet the low risk profile criteria and wishing to benefit from the principle of proportionality should notify their supervisory authority.

6. Insurance and reinsurance captives and entities identified as having a low risk profile are exempt

The criteria depend on the type of activity:

Life insurance	Non-life insurance
Basic Solvency capital requirement relating to interest rate risk is less than 5% of technical provisions (gross of reinsurance)	Combined ratio net of reinsurance < 100%
Premiums issued in Member States outside of home jurisdiction represent less than 5% of the total annual gross written premiums	
Technical provisions gross of reinsurance not higher than €1 billion	Gross written premiums not higher than €100 million The annual amount of gross written premiums relating to insurance vehicle bodies land, rail, air, maritime goods transported, to credit insurance and sureties globally represent less than 30% of total annual gross written premiums
Not investing more than 20% of total investments in non-traditional investments	
Accepted reinsurance, measured by gross written premiums, not higher than 50%	

If the supervisory authority does not object to its low risk profile classification, the undertaking may:

- conduct an Own Risk and Solvency Assessment (ORSA) only every 2 years,
- avoid including climate change scenarios in its ORSA,
- avoid establishing a liquidity risk management plan,
- be exempt from the audit of its Solvency 2 balance sheet,
- if the options and guarantees are immaterial, carry out a prudent deterministic valuation of life insurance liabilities,
- review its written policies only every 3 years (provided there are no material changes in the insurance company),
- assign several key functions to the same person, with the exception of internal audit duties, provided that potential conflicts of interest are taken into account.

The Commission also accepts that entities not identified as a "Low Risk Profile" undertakings may submit a request to their supervisory authority to benefit from certain proportionality measures. They should explain the reason for their request, as well as the nature, size and complexity of the risks inherent in their activity.

Simplified calculation of the Basic Solvency Capital Requirement (BSCR) for immaterial risks

A new simplified approach may be used to assess the capital requirement when the risk is immaterial. This approach prevents the insurer from having to perform the full calculation for a risk module each year, if this component accounts for only a very marginal fraction of the entire BSCR.

If a risk is immaterial, for a period of 3 years after a "conventional" calculation of the capital requirement for that risk, the cost of capital may be estimated by determining a change proportionate to the change in the exposure to that risk.

To be considered immaterial, a risk should not account for more than 5% of the BSCR and the capital requirement for all risks subject to a simplified calculation may not exceed 10% of the BSCR.

The Commission adds a new chapter containing provisions to better manage liquidity risk

Liquidity risk has long been addressed in banking regulations, notably through compliance with liquidity ratios (LCR and NSFR), and in asset management with the obligation to perform liquidity stress tests and the possibility of implementing certain mechanisms such as swing pricing, notice periods or redemption gates.

The new chapter aims i) to encourage insurers to improve their management of liquidity risk and ii) to enable the supervisory authorities of the Member States to intervene in the event of risks liable to threaten policyholder protection or the stability of the financial system.

Insurance undertakings should submit a liquidity risk management plan to their supervisory authority, including the cash flows generated by their assets and liabilities. They will need to establish indicators to identify any liquidity stress.

Where undertakings are found to have inadequate liquidity, the Commission believes supervisory authorities should be able to require the undertakings to strengthen their liquidity position and, in exceptional circumstances, the supervisory authorities should have the power to temporarily suspend redemption rights on life insurance contracts.

EIOPA is tasked with drawing up guidelines, in particular to clarify what constitutes exceptional circumstances.

The Commission includes several measures aimed at strengthening policyholder protection, including in the event of default by an insurance undertaking

The Commission adds several provisions to expand the definition of insurance groups, clarify the rules for calculating group solvency ratios and improve overall group supervision.

It also proposes multiple amendments to increase the exchange of information and cooperation between the home jurisdiction supervisory authority and the host jurisdiction authority for cross-border activities.

What's next?

The proposal negotiation phase with the European Parliament and the Council can therefore begin. Although work on Level 2 texts will move forward at the same times as negotiations on the directive, the review process will continue for several years.

In addition, at the same time as its proposal for the Solvency 2 reform, the Commission presented a draft Directive on the Recovery and Resolution of Insurance and Reinsurance Companies.

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