

To: Economics & Finance Committee, Public Affairs & Communications Committee, Solvency II WG
From: ECOFIN department
cc:
Date: 17-11-2023
Reference: [Click or tap here to enter text.](#)
Subject: Solvency II - Outreach requested ahead of trilogue on 22 November

Action requested

- Ahead of the next trilogue on Solvency II on 22 November, members are kindly requested to engage with their respective Council representatives.
- In particular, members are invited to reiterate the industry key messages in relation to the LTG measures and internal models and to use the Insurance Europe analysis and counter-arguments on the Commissions recent non-papers (see Annex to this memo and [ECO-SLV-23-215](#))
- Members are invited to keep the secretariat informed about their outreach and feedback received.

Summary

The fourth political trilogue on Solvency II will take place on 22 November. This will be a key meeting where a number of important elements will be discussed, including long-term guarantee (LTG) measures, sustainability, cross-border activities, proportionality and reporting.

In view of the meeting, the European Commission (EC) has produced several non-papers to inform the discussions and provide additional views. The secretariat has shared a summary of the non-papers with members ([ECO-SLV-23-211](#)).

In particular, the secretariat would like to draw members' attention to the:

- [EC non-paper on LTG measures \(ECO-SLV-23-206\)](#): The secretariat strongly encourages members to engage with their respective Council representatives in relation to the Commission's views on key industry priorities, including the risk margin (CoC), extrapolation and volatility adjustment.
- [EC non paper on reporting \(ECO-SLV-23-208\)](#): The secretariat strongly encourages members to engage with their respective Council representatives in relation to the EC's views and recommendations on standard formula reporting for internal model users.

In their engagement, members are invited to refer to the Insurance Europe key positions for trilogues (see [here](#)) as well as the arguments in the annex below.

Annex – IE views and counter-arguments on Commission analysis in non-papers

EC non-paper on LTG measures ([ECO-SLV-23-206](#))

■ **Risk margin – Cost of Capital**

In its argumentation against a decrease in the CoC rate, the Commission notes that interest rates have increased significantly and gives the example of 10-year government bonds yielding 3.5%. It further explains that the cost of equity for some companies is currently around 12%.

IE view: The Commission analysis is flawed for a number of reasons and a 4.5% CoC is technically justified.

1. The level of the prevailing interest rates does not have an impact on the level of the Solvency II Cost of Capital rate. The CoC rate is defined by SII text as the rate **above** the risk-free rate that an undertaking would require to support the own funds. **So the Commission’s reference to current 10-year government bonds is not relevant and no justification to question a 4.5% as a reasonable calibration.**

Directive Art 77 para 5 (3) - The Cost-of-Capital rate used shall be equal to the additional rate, above the relevant risk-free interest rate, that an insurance or reinsurance undertaking would incur holding an amount of eligible own funds, as set out in Section 3, equal to the Solvency Capital Requirement necessary to support insurance and reinsurance obligations over the lifetime of those obligations.

2. The Solvency II Cost of Capital is a parameter designed for a very specific Solvency II purpose – it is not at all the same as the general meaning of Cost of Capital or Cost of Equity used more widely by investors and companies. **We are very surprised that the Commission is again making an irrelevant and incorrect reference to a company cost of equity to question 4.5% as a reasonable calibration.**

We have already provided explanation as to why the Solvency II Cost of Capital would always be far lower than the Cost of Capital as used in general investment and company return on capital context (see slides below from the document [ECO-SLV-23-215](#)):

Cost of Capital (as generally defined) ≠ SII Cost of Capital

Cost of Capital as generally defined:

The total average rate a company is expected to pay for the capital it employs on behalf of debt, equity, and preferred stockholders

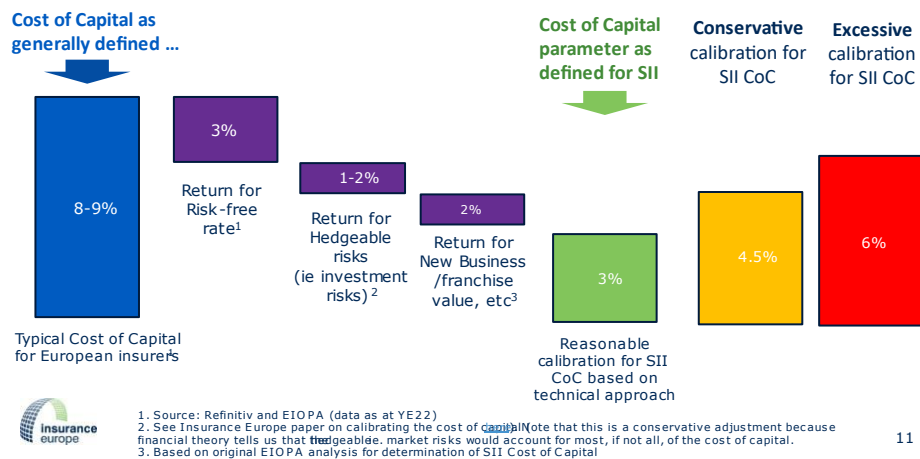
- **Includes** the return needed to cover the risk-free rate
- **Includes** the return needed to cover all risks
- **Includes** the return needed to cover in-force (ie run-off book), new business & franchise/brand value of business

The Solvency II Cost of Capital is a specific parameter

The additional margin above the riskfree rate that would be needed to finance a “reference undertaking” to accept a run-off book of liabilities from a failing insurer covering only the non-hedgeable risks relating to that portfolio

- **Excludes** the return needed to cover risk free rate
- **Excludes** the return needed to cover all risks
- **Excludes** the return needed to cover new business & franchise/brand value of business

Cost of Capital (as generally defined) \neq SII Cost of Capital



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And the Cost of Equity mentioned by the Commission will always be higher than the Cost of Capital as generally defined because the Cost of Capital is the weighted average of Cost of Debt (eg 4-6%) and Cost of Equity (eg 9-12%).

Insurance Europe (and CROF/CFOF) analysis, taking into account the above adjustments, shows that a technically justified Solvency II CoC rate should be in the region of 3%.

The unjustified and therefore irrelevant comments by the Commission should not impact the discussions. A 4.5% level is already a conservative calibration, does not conflict with economic evidence and would be a technically justified level. It would furthermore contribute to the joint co-legislators' objectives of the Solvency II review, namely, to provide incentives for insurers to contribute to the long-term sustainable financing of the economy.

■ Volatility Adjustment – risk correction

The Commission argues that continuing to link the risk correction to the fundamental spread could result in additional "overshooting" when combined with the other improvements to the Volatility Adjustment. It further states that this would go against one of the objectives of the review which is "to avoid overshooting".

IE view: The fundamental spread approach has proven to work well and there is no need to change it. The Commission's proposed approach would undermine the other improvements to the VA, increase artificial volatility and increase incentives for procyclical investment behaviour.

Undershooting is a much greater issue than overshooting. While overshooting can occur, there are existing and proposed mechanisms to deal with it. Contrary to the Commission's view, changing the risk correction would go against one of the co-legislators' objectives, namely to mitigate excessive short-term volatility in insurers' solvency positions.

1. The risk correction adjusts the market yields of the reference portfolio for expected losses and other risks of the assets ie. downgrade and default risk.

The fundamental spread approach has proven to work well to assess downgrade and default risk. EIOPA analysis of fundamental spreads vs incurred losses from default and downgrade in LTG Reports [2018](#), [2019](#), [2020](#) evidences this. Note also that the Commission does not propose to change the fundamental spread approach for the Matching Adjustment.

2. EIOPA's analysis of the risk correction was flawed as it concentrated on less than 1% of the assets in the reference portfolio and focused on spread changes and not defaults.

Insurance Europe analysis (see [ECO-SLV-23-215](#)) showed that the current fundamental spread approach is already conservative as it contains a floor (35% of the long-term average spreads of non-government bonds and 30% of the long-term average spreads of government bonds).

3. Overshooting and undershooting exist largely due to the differences in composition of individual insurers' investment portfolios vs the reference portfolios (ie basis risk). Improvements to the VA are needed because the current VA approach results in significant undershooting across many markets. Addressing undershooting has the possibility of creating some overshooting but there are already several mechanisms to deal with the possibility of increased overshooting.
 - a. **Capital add-on:** The Directive empowers NSAs to make a capital add-on where it assesses the risk profile of an undertaking applying the VA deviates significantly from the assumptions underlying the VA. (Article 37 para 1 (d)).
 - b. **The proposed Credit Spread Sensitivity Ratio (CSSR):** This adjustment mitigates against overshooting due to differences in the spread sensitivity of the assets and liabilities.
 - c. **The Enhanced Prudency Principle for DVA users:** This adjustment mitigates against overshooting in the SCR for internal model firms who use the DVA approach.
4. Among the co-legislators stated objectives for the review were 1) ensuring that insurance companies can fulfil their role as long-term investors and 2) mitigate excessive short-term volatility in insurers' solvency positions.

Changing the risk correction as per the Commission proposal will restrict insurers' ability to provide long-term products and make long-term investments and undermine the other VA improvements which aim to reduce artificial volatility. **Changing the risk correction does not deliver on the co-legislators stated objectives.**

In addition, it is worthwhile to note that key parameters relating to the VA are already included in the Level 1 text including the General Application Ratio and the country component (to be replaced by the macro-VA).

■ **Extrapolation of RFR curves – First smoothing point and convergence parameter**

The Commission notes that the co-legislators have already agreed to set out the value of the FSP in an implementing act which can only be reviewed every two years. It questions whether it is necessary to introduce a parameter for the FSP in the Directive. Instead, it suggests that the FSP for the Euro could be set to be 20 years at date of entry into force.

IE view: The FSP should be stable parameter and should be set at 20 years in the Directive.

Regarding the weight of the UFR (ie the formula defining the convergence parameter), the Commission notes that the co-legislators' positions are not far apart and that the prevailing economic conditions have reduced the impact of the proposal. In this context, it argues that now is a good time to adjust the extrapolation mechanism to increase its risk sensitivity.

IE view: The weight of the UFR in the calculation should be set as a minimum of 80% for all currencies in the Directive, in line with Parliament proposal. A final convergence parameter of 15% for the Euro (and 70% for the SEK) is technically justified.

1. Industry recognises the supervisory request to include more data in the extrapolation calculation.

However, as noted in recital 30 of the Omnibus II directive, the extrapolation and associated parameters were chosen to avoid artificial volatility and to encourage good risk management. The current approach has proven to work well including through a period of low and negative interest rates.

Therefore, in our view, the impact on capital requirements or volatility from methodological changes should be limited.

2. Changes to the UFR have already been made in 2018 to account for the possibility of a continuation of the low interest rate environment.
3. Introducing the new methodology with a 10% convergence parameter increases the volatility of the framework and introduces the possibility of procyclical behaviours – contrary to the stated purpose of the extrapolation.

We agree with Commission that it has limited impact in current market environment but will (significantly) increase capital requirements if rates move lower again. EIOPA's impact assessment from June 2020 showed the new approach to have an impact of around €90bn at that time.

EC non-paper on reporting ([ECO-SLV-23-208](#))

■ **Standard Formula reporting for Internal Models – recital**

On request of the co-legislators to draft a recital in order to clarify the meaning of an “*estimate of the Solvency Capital Requirement determined in accordance with the standard formula*”, the EC has suggested the following modifications to its proposed recital (44):

“(44) As part of the supervisory review process, it is important for supervisory authorities to be able to compare information across the companies they supervise. Partial and full internal models allow to capture the individual risk of a company better and Directive 2009/138/EC allows insurance and reinsurance undertakings to use them for determining capital requirements without limitations stemming from the standard formula. However, partial and full internal models make comparisons across companies more difficult and supervisory authorities would therefore benefit from access **also to the outcome of the calculation of estimates determined under the standard formula capital requirements**. All insurance and reinsurance undertakings **using a full or partial internal model** should therefore regularly report such information to their supervisors **an estimate of the Solvency Capital requirement determined in accordance with the standard formula. Such an estimate should appropriately reflect the methods and underlying assumptions of the standard formula facilitating a proper supervisory assessment. In order to avoid excessive burden for undertakings when determining the estimate they would be allowed to make use of information derived from the relevant simplifications in the standard formula laid down in this Directive and its delegated acts. The underlying assumptions where such simplified approach is used to determine the estimate of the Solvency Capital Requirement should be clearly explained to the satisfaction of supervisory authorities.**”

IE View: The proposed recital, as currently drafted, is unclear and may contribute to further confusion.

The recital should be revised to explicitly state that the approach to the estimate should be explained to the satisfaction of the supervisory authorities but that a range of simplifications should be available given that the estimations provided are to be used as supplementary information and not intended to be used as information for supervisory purposes.

1. Internal models are fundamental to the Solvency II framework. They are developed to be reflective of the individual risk profile of the insurer and therefore allow risk to be measured more accurately. They are already subject to very extensive approval requirements conducted by national supervisory authorities. These are an integral part of companies' risk management and should not be undermined through inappropriate benchmarking or standardisation.
2. It is important to recognise the extensive and rigorous supervisory approval and reporting processes already in place and to preserve (re)insurers' ability to reflect their own assessments of risks through the use of internal models. In this respect, adding a requirement for internal model users to report regularly to supervisors an estimation of the SCR calculated with the standard formula would undermine the internal model.