

To: Valdis Dombrovskis
Vice-president for the Euro and Social Dialogue, Financial Stability, Financial Services and Capital Markets
Union
European Commission
Rue de la Loi, 200
1040 Brussels - Belgium

Our
reference: EXCO-17-065

Subject: Insurance industry concerns over Solvency II and proposed actions for the Commission

Brussels, 1 June 2017

Dear Vice-President Dombrovskis,

I would like to bring to your attention key concerns emerging from the application of Solvency II, together with proposals for further steps needed to ensure Solvency II can achieve its initial aims and avoid unintended consequences.

Solvency II is probably the most sophisticated and comprehensive risk-based regime in the world, with policyholder protection rightfully set at the centre of its design. While the industry continues to support the objectives of Solvency II, it believes that, in its current form, Solvency II does not deliver on these aims because of a number of flaws in design and calibration.

We welcome that the Commission is committed to using the review processes built into Solvency II to make needed improvements and believe that the 2016 call for advice to EIOPA covered many of our concerns. We look forward to engaging on these to identify appropriate solutions. However, **at this stage**, some important **issues are not included in the ongoing discussion**. In addition, some of the changes under consideration by EIOPA could worsen rather than improve Solvency II. We would therefore like to share with you the following key areas of concern and the steps that we believe can be taken to improve Solvency II and avoid unnecessary damage to policyholders, the industry and the wider economy.

The Volatility Adjustment and the Matching Adjustment

The Matching Adjustment (MA) and the Volatility Adjustment (VA) are the key parts of the long-term measures intended to act as countercyclical measures. **The MA works very well as a countercyclical measure, but conditions for its use are so constraining that only about 15% of liabilities qualify**, and these come from **only two member states**. For all other liabilities, the VA is the only option. However, **the VA does not provide the countercyclical effects needed and risks creating false incentives** for a number of reasons, including:

- a) it is based on a reference portfolio that has no link to the actual asset portfolios of companies;
- b) its impact is diluted by a 65% application ratio, by relying solely on bonds in a portfolio comprising also equity and property and by the inclusion of unrelated assets (ie unit-linked);
- c) the country adjustment does not work; and
- d) its recalculation in the spread risk module as a dynamic adjustment, taking into account the solvency capital requirement spread level, is not recognised.

The VA will work as intended only if its design, dynamic application and calibration are improved. Improvements needed include a tailored reference portfolio that links the VA to the company's own assets and are key to ensuring that the right risk management incentives are set. Similarly, the MA will be applicable beyond two member states only if some of its unnecessary restrictions are removed (eg the ring-fencing requirement, excessive restrictions on assets). In developing improvements, effort should be made to avoid unnecessary complexity and a level playing field should be a guiding principle so that situations that are economically equivalent receive the same treatment.

Risk free rates

The methodology for determining risk-free interest rates was a key part of the long and difficult Solvency II political negotiations. The final agreement included a wide Solvency II review, to be completed by 2020, which would look into the overall approach to valuation and risk measurement. **There should be no piece-meal changes to risk-free interest rates and any changes should only be considered as part of the wider 2020 Solvency II review.** Areas of methodology and calibration relating directly to the risk-free rates that should remain unchanged include the Ultimate Forward Rate (UFR), extrapolation, last liquid points and SCR for interest rate risk. As highlighted in previous communications, we strongly believe that the existing Solvency II approach to interest rates is already extremely conservative.

Capital charges for investments

For insurers' assets including equities, property and corporate bonds, **the capital requirements remain unnecessarily high because they are calibrated based on the flawed underlying assumption that insurers invest like short-term traders** and are fully exposed to market price volatility. This exaggerates the risk and creates real barriers to greater investment. We have raised this issue over recent years in the context of the Capital Markets Union, where we have urged the Commission to take swift and bold action to remove such investment barriers. While we welcome work by the Commission on infrastructure and appreciate initiatives on securitisations, unrated debt and unlisted equity, this impacts probably less than 5% of our total assets. **In the short-term we urge the Commission to make further changes in the treatment of equity and strategic participations risk modules, taking into account long-term investment strategies,** to further support insurers' ability to invest in these assets for long periods. We have provided specific proposals to the Insurance Unit and EIOPA.¹ **Then, as part of the wider Solvency II review, steps are needed to move away from a short-term trading approach** and calibrate equities, property, and corporate bonds in line with the real long-term risks not trading risks.

Risk Margin

The risk margin is, rightly, one of the aspects of the Solvency II framework being investigated as part of the 2018 Solvency II review because its calibration and design are flawed. When designed, it was expected to be relatively small, but in practice **the risk margin can be very large and very volatile, with no evidence that it bears any relation to its intended purpose** (ie to cover the cost of transferring the liabilities in the case of a failure which can in any case be covered by the MCR). For example, recent EIOPA data shows that in a number of member states in 2016 the risk margin for life business was more than 40% and even up to 50% of the capital requirements. There is also evidence that it is very volatile. In the short term, and **as part of the 2018 review, improvements are needed to address both the excess size and volatility, while under the wider review its whole purpose and raison d'être should also be reconsidered.** Changes in the risk margin are key to allow insurers to continue providing long-term products to policyholders, including savings, guarantees and protection products.

¹ <https://www.insuranceeurope.eu/proposal-alternative-treatment-equity-risk-under-solvency-ii-strategic-participations-and-long-term>

Loss absorbing capacity of deferred taxes

Taxes form a very significant element of insurers pre-tax profits and therefore their balance sheets and solvency capital. Given that Solvency II requires the impact on all assets and liabilities to be taken into account it should be of no surprise that taxes, including tax assets, can and should have a significant and real economic impact on overall capital. Solvency II already has sufficient limits and controls on tax assets and therefore **no further limits on deferred taxes are required.**

Proportionality

In addition to the above measurement issues, the industry is strongly concerned that, for all companies, and especially for small ones, Solvency II can be excessively burdensome. Proportionality was defined as a **key principle of the Solvency II framework and is vital to its success.** However, its practical application appears to be very limited or non-existent across member states and companies. In some cases, even the few specific allowances for smaller or simpler portfolios, such as lower reporting requirements or simpler governance requirements, are being ignored. More generally, NCAs appear to be unwilling to make reasonable judgements that would allow companies to apply proportionality, and instead refuse simplifications or set excessive burdens of proof. **We ask that the Commission makes practical application of proportionality a priority issue and identifies concrete steps for achieving this. One such step should be to reverse the burden of proof,** so that a company that has followed strong documented internal processes to arrive at a simplification decision under the proportionality principle would be allowed to apply it, unless their supervisor can justify why not.

Looking ahead

In the months and years to come, we will continue to provide input and support the Commission's work on the Solvency II review and CMU-related initiatives, which include the risk margin and deferred tax issues as well as a range of other important areas of improvement. As indicated above, we do however urge the Commission to take further action in the short-term to remove barriers to long-term equity investments and strategic participations and make the proportionality principle work in practice.

The wider Solvency II review - which will include the long-term guarantee measures, as well as the concerns raised about Solvency II's trading assumption - has a deadline for the end of 2020. However, we urge the Commission to start work this year given the importance and complexity of the issues that need to be covered. As noted in my previous letter which focuses on the UFR, we would strongly encourage the Commission to set up an Expert Group, so that regulators, supervisors, academics and the industry can together assess the emerging issues and potential solutions and develop recommendations.

With appropriately considered and timely actions, the Commission can help Solvency II achieve its initial goals of being a strong risk-based framework that ensures very high levels of policyholder protection applied in a converging way across Europe. Reviewing Solvency II is key to avoiding creation of unnecessary barriers to insurers providing good value protection, pensions and savings products and supporting growth through long-term, stable investment.

We thank you in advance for considering our comments and we would be happy to provide further details on the points raised above.

Yours sincerely,



Sergio Balbinot
President