

## Key messages on Solvency II: LTG and Sustainability

### **Why improvements are needed:**

- Certain aspects of how available capital and required capital are currently measured do not reflect the long-term insurance business model. This leads to unwarranted artificial volatility in solvency ratios and excessive overall capital requirements. Long-term products and long-term investments are particularly affected and this has several detrimental consequences for European customers and for the broader European economy.
- 1. **It makes long-term products unnecessarily expensive for customers**, and creates disincentives for insurers to offer them. Such long-term products are not only wanted and needed by many customers, but they provide insurers with the foundation to invest in long-term assets.
- 2. **It becomes more difficult for insurers to justify investing in real assets (such as equity, corporate bonds and property)**, and reduces their capacity to do so. Insurers are pushed to invest in portfolios with low returns for policyholders, while limiting insurers' ability to invest in the assets needed to drive the sustainable transition.
- 3. **It worsens the competitive position of EU insurers** – both globally and as long-term investors in the European economy. Other global insurers generally have more capacity to deploy capital to pursue risk-taking, innovation and investment – both at the global level and within Europe. This will have a negative impact on the EU's leadership in the global (re)insurance industry, might substantially harm the attractiveness of the EU as base for global insurance, and discriminates against EU insurers' long-term investments within the European economy in comparison with foreign investors.

### **What key improvements are needed:**

- **Risk margin:** The Commission has proposed some improvements which would lower the level and volatility. However, it would be meaningful and justified to target a reduction of at least 50%.
  - Level 1 text is needed which guides the calibration of the lambda and Cost of Capital parameters and/or ensures an overall impact which is consistent with a 50% or greater reduction in the Risk Margin relative to current levels
- **Volatility adjustment:** The Commission's proposals to improve the effectiveness of the volatility adjustment, with the exception of the Commission's intention to change the 'risk correction' parameter. This would increase procyclicality and artificial volatility of Solvency II, in particular in a crisis situation, and undermine the other improvements of the volatility adjustment. The current risk correction is already conservative, and it should remain unchanged.
  - The Rapporteur's current compromise text should remain because it is already simple and principle based and consistent with the same element within the Matching Adjustment which is already in Level 1.
- **Extrapolation of risk-free rates:** The Commission has proposed a new extrapolation method. However, the proposed calibration would create a new source of volatility (by transferring short-term interest-rate volatility to the reflection of long-term interest rates in Solvency II), incentivise increased derivative usage, and exaggerate the valuation of liabilities when interest rates are low and underestimate liabilities when rates are very high. This should be addressed by a more appropriate calibration of the "convergence" parameter.
  - Level 1 text is needed which limits level of the convergence parameter to 15% or higher for Euro and takes into consideration the market characteristics of non-Euro currencies when determining the starting point of the extrapolation and the convergence parameter. In particular for SEK, the convergence parameter should be around 70%.
- **Equity capital charges:** A significant portion of insurers equity investment should qualify for the 22% capital charge because this better reflects the real risk faced by insurers and is needed to allow greater equity investment. Any changes to the symmetric adjustment must avoid creating artificial volatility.
  - Level 1 text is needed to ensure that the symmetric adjustment should not apply to unit-linked and similar insurance products where the policyholders choose what to invest in and bear the investment risk.

**Why customers would remain extremely well protected**

- Solvency II is a very comprehensive, risk-based framework which provides multiple layers of protection that customers have, and will continue to have, after the improvements outlined above.
- These include:
  - **All expected claims and expenses valued in a conservative way** and fully funded with assets.
  - **A risk margin** (which would remain at an aggregate level of at least €60bn after the changes). The Risk Margin is only needed in the rare case of an insurance failure and in such cases there would be a **substantial minimum capital requirement** (MCR) also available (with an aggregate level of €240bn).
  - A **high solvency capital requirement** (SCR) above this, which covers combinations of up to 28 different risks, calibrated to a 1-in-200-year level of safety and which, if breached, allows for early intervention by supervisors. Note that changes to the interest risk capital requirement, supported by the industry, will result in significant increases in this element of the capital calculation
  - Very **substantial additional capital buffers** set by the companies in line with their internal targets.
- While Solvency II is based on a very high, 1-in-200-year protection level, EIOPA also tests additional even more extreme scenarios in its EU-wide stress tests going even to 1-in-1000 events. The results of these exercises show that insurers can meet customer claims after such extreme situations and would be able to do so even after the necessary improvements.
- Note a €100bn reduction in overall capital requirements would represent only 6% of total industry solvency capital (€1660bn) or 10% of excess capital (above the SCR).

**The multiplier effect – how every extra euro of capital made has a much larger impact on investment**

Every €1 of extra capital available for insurers can generate...



€1.70 in equity investments



€6 investment in green bonds



€1000 in windstorm protection

€3 if the capital charge for long-term equity is properly corrected

**The level 2 vs Level 1 issue:**

- Achieving a good outcome for the LTG topics (extrapolation, risk margin, volatility adjustment, interest rate risk SCR) regardless of whether the technical details/formulas are in level 1 or level 2 remains the core objective. However, to avoid leaving the outcome of the overall SII Review uncertain and cede decisions to EIOPA/Commission, Insurance Europe sees a **clear need for the Parliamentary compromise agreement to include new or amend existing Articles/Recitals in Level 1 that will help ensure the reduction in capital and volatility will be more ambitious than currently foreseen by the EC Level 1 and draft level 2 proposals.**

### ***International competitiveness***

- The European (re)insurance industry has become an international success story in recent decades. However, Solvency II framework is more volatile than other global regulatory regimes leading to competitive distortions between international groups that compete with each other in markets around the world. So European (re)insurers have to hold more capital for the same business than other global (re)insurers, and are subject to greater regulatory pressure to act with a short-term instead of a long-term perspective.
- The IAIS's Insurance Capital Standard (ICS) project, which is based on Solvency II, was intended to create a more level playing field for internationally active groups with a single standard. Although it is still under development and may never be agreed, it provides a basis for comparison. The ICS has lower capital requirements than Solvency II, but it is still considered as significantly too onerous and volatile by our global competitors and their supervisory authorities (e.g. US, Canada and Japan) to be applicable in their home market. Also, the current revisions to the UK Solvency II regime will imply material improvements for UK-based insurance groups.
- Even after the improvements needed, Solvency II would remain a global gold standard.

### ***Sustainability***

- European insurers strongly support the drive towards sustainability and are ready to build on their current actions to contribute further to the transition to a more sustainable society and to play their role in achieving the targets of the EU Green Deal.
- Sustainability is a key element of the 2020 Solvency II review and its appropriate inclusion in the prudential framework will provide confidence and clarity that climate, environmental and wider sustainability risks are appropriately managed by insurers.
- Insurers are already required to manage and report on sustainability risks and new reporting due shortly will significantly add to that. The EC's sustainability proposals for the SII review are supported by the industry and will also add detail to the existing and upcoming requirements. All of this needs to be taken into account before adding new requirements – and it would be much more efficient to have EIOPA assess the effectiveness of all existing requirements on insurer's reporting and management of sustainability risks over the coming years. It could also be suggested that EIOPA should provide (eg after 3 or 5 years) recommendations to the EC on whether there are any gaps or changes needed.
- Requirements for transition plans are included in the CSDDD and so are not needed in SII. If they are included, then they should be fully aligned with CSDDD proposals along with a clause that removes them from SII once insurers are covered by CSDDD.