insurance europe

Insight Briefing

2018 Solvency II review

Key messages on EIOPA advice to the European Commission

What is the 2018 Solvency II review?

Since January 2016, the EU's (re)insurers have been governed by the Solvency II regulatory regime. This replaced 28 national regimes with a single set of risk-based capital requirements and advanced risk-management principles. The high level of policyholder protection it offers is strongly supported by the industry.

Two major reviews were built into the Directive that would allow for improvements. The first review, due by the end of 2018, focuses mainly on simplifications and fixing technical issues with the capital calculations (ie, in the Level 2, delegated regulations). The second, due by the end of 2020, allows for more fundamental changes — through the Level 1 legislation — and addresses broader issues, including the concerns that Solvency II creates unnecessary constraints for long-term guarantees and long-term investments.

Some welcome improvements in the area of infrastructure were already made by the Commission as part of its work on the Capital Markets Union (CMU) project, which aimed to remove regulatory barriers to investment. However, efforts so far have focused on a very limited part of insurers' balance sheets. As such, the Solvency II reviews will need to achieve more.

For the 2018 review, the Commission asked the European insurance supervisor, EIOPA, to provide technical advice. Delivered in February 2018, the advice covered the areas requested by the Commission, but also covered areas where EIOPA provided proposals on its own initiative. The Commission will consider this advice, come to a view on appropriate changes and submit delegated regulation to the European Parliament and Council of the EU by the end of 2018.

Why does Solvency II matter?

Solvency II has a significant impact on the cost, design and availability of insurance products and on insurers' investment decisions. Care needs to be taken so that insurers have enough capital to protect customers. However, care must also be taken to avoid setting excessive capital requirements. This can happen if calibrations are unnecessarily conservative or because the wrong risks are being measured.

Excessive capital can increase the costs for customers and even make some products, such as guaranteed savings products, simply unavailable. Excessive capital also restricts the ability of insurers — who have more than €10tn of assets under management — to allocate capital to long-term investments. This includes investments that were identified as much needed by the Commission's action plans for the Capital Markets Union and Sustainable Finance.

Can the 2018 review make a difference?

The 2018 review provides the opportunity to both improve Solvency II and to take steps towards removing disincentives for long-term investment. By doing this, the Commission can also enhance the ability of insurers to support the EU's growth objectives.

While EIOPA's advice includes several helpful improvements to a range of smaller issues, disappointingly, these are overshadowed by advice that not only ignores the EU's growth objectives, but actually conflicts with them. Regrettably, EIOPA's impact assessment has several weaknesses and ignores the effects on the cost and availability of products and on long-term investment. It is therefore key that, before the Commission finalises its views, it undertakes a comprehensive impact assessment, looking at the cumulative impact of EIOPA's proposed changes.

What needs to change now?

Risk margin and long-term equity calibrations

There are concrete steps that the Commission should take as part of the 2018 review that have sound prudential justification and would support the European growth and investment ambitions of the Juncker Commission:

- **Reduce the cost of capital in the risk margin**, by recognising the impact the current excessive risk margin can have on insurers' long-term products and their ability to invest long-term.
- **Reduce the capital requirements for long-term investment in equity** beyond unlisted equity. These are currently excessive when compared to the real risks and add to the disincentives for increasing investment.

Equities within a diversified portfolio are required, for example, by pension products to help provide the good long-term returns needed to cover the costs of living in retirement. Equity investment can also be a driver for growth and employment in Europe. Significantly lower capital charges can be justified without putting customers at risk — greater investment can benefit customers, as well as the economy.

While the risk margin is only a theoretical concept, it currently removes over €200bn of potentially productive capital from insurers' balance sheets. It is not needed to pay customer claims, but is linked to the theory that insurers' liabilities should be valued as if they are being traded. For some long-term products, it has the same effect as doubling the solvency capital requirements. There is extensive evidence that the cost of capital, a key element in the calculation of the risk margin, should be significantly lower than the current 6% and this evidence should not be ignored. Given the size of the risk margin problem, some improvements should be made in the 2018 review. Wider questions on the need for and design of the risk margin can then be a priority for the 2020 review.

What shouldn't change?

Interest rate risk and LAC DT

EIOPA's proposed changes to interest rate risk and loss absorbing capacity of deferred taxes (LAC DT) conflict with the Juncker Commission's growth objectives and should not be taken forward.

- **No change to the calibration of interest rate risk.** A change is not required to ensure policyholder protection, but would increase barriers to long-term business. Interest rates are directly related to wider and fundamental questions on valuation methodology and should be dealt with in the 2020 review.
- **No arbitrary limits should be imposed on the loss absorbing capacity of LAC DT.** Solvency II already requires high standards of evidence to support the use of LAC DT.

The LAC DT limits relate to the percentage of tax recovery that can be used to offset capital requirements. The Commission should reject the artificial and conservative limits that were proposed by EIOPA under the pretext of convergence. Solvency II already provides a very high level of harmonisation across Europe, with increased convergence expected over time, as companies and supervisors gain experience of the framework. Several considerations dictate decisions on LAC DT limits, including the nature of the business, the profile of the undertaking and the tax regime. There are legitimate reasons, therefore, for keeping the current principle-based approach that encourages supervisory judgement and dialogue, rather than applying arbitrary limits that would make the framework significantly more conservative and put further unnecessary capital pressures on insurers.

The interest rate approach is already conservative and the current calibration of interest rate risk should not give rise to prudential concerns. EIOPA's stress test exercise already demonstrated the resilience of the European insurance industry to a prolonged period of extremely low rates. Any changes to interest rate risk now would have a negative impact on insurers' long-term products and long-term investment, as well as their ability to invest in non-fixed income assets, such as equity. EIOPA's impact assessment in this area was based on simplifications and proxies and appears to underestimate the actual negative impact of change. The Commission had good reasons not to ask EIOPA for advice on this area for the 2018 review, because of the links with wider interest issues that will be covered in the 2020 review.

What needs to change later?

The full 2020 review needs to take a holistic view of improvements that would allow Solvency II to correctly reflect the long-term nature of insurance business and investments. As mentioned above, the design of the risk margin should be made a priority in the 2020 review. The calibration of interest rate risk should also be reviewed in 2020, when wider issues related to the valuation of liabilities and interest rates will be addressed.

Certain elements of Solvency II need adjustment as they are based on the mistaken assumption that insurers trade all their assets and liabilities at all times. This means that the wrong risks are being measured, leading to excessive capital requirements and artificial volatility. This was highlighted in the report[1] of the High-Level Expert Group on Sustainable Finance set up by the European Commission. In reality, insurers can and do invest long-term and, unlike traders, they are rarely — if ever — forced to sell their entire portfolio at a bad time.

Getting the measures wrong matters to consumers because it leads to higher premiums, lower benefits and less choice. It matters to the economy because it limits the ability of insurers to support economic growth.

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1 https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

