Solvency II: A balanced review

Contribution by Fausto Parente to the Eurofi Magazine - September 2021

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In December 2020, the European Insurance and Occupational Pensions Authority (EIOPA) concluded its review of Solvency II. As we wait for the European Commission proposals in response to our Opinion, it is worth recapping the core elements of EIOPA's Opinion.

Since its implementation, Solvency II has been a step change in how insurers approach their relationship to risk. Our approach was therefore one of evolution rather than revolution. Since its implementation, the insurance industry has better aligned capital to risk, uses a risk-based approach to assess and mitigate risks, which means that it can better price them. Insurers have also significantly strengthened their governance models and their risk management capacity.

The coronavirus pandemic underlined this view. The crisis has shown us that Solvency II proved effective in protecting the sector from market turmoil.

Nonetheless, for a regulation to remain effective, it must also remain fit for purpose. Therefore, we have to recognise that the situation today is much different to when Solvency II was conceived.

The realities we had to consider as part of our review included the ongoing low interest rate environment the impact this has had on insurers' business models. We also had to consider climate change which, while not new, has taken on a more urgent dimension; and, of course, the COVID pandemic.

Starting with the low interest rate environment, given the massive intervention measures from central banks as a result of the pandemic, it is clear that the 'low for long' scenario will continue for a long time yet. The framework must therefore take account of the economic situation, notably with respect to the capital requirement for interest rate risk. The current interest rate requirement does not reflect the fall of interest rates experienced during the last years and ignores the existence of negative interest rates. Our Opinion therefore proposes changes to the treatment of interest rate risk, as well as to discount curves used by insurers, in particular regarding extrapolation.

Insurers were able to withstand the shocks of the pandemic in part due to the work done during years following the implementation of Solvency II, entering the crisis with a robust capital position.

Looking beyond COVID, the insurance sector has an important role to play in supporting the economic recovery. Long-term investments – the type of investments favoured by insurers – are essential to foster economic growth, develop infrastructure and boost employment and should be encouraged.

In our Opinion, we have taken into account the nature of the long-term insurance business, creating conditions for more long-term investment. We are therefore proposing the changes to the volatility adjustment, the risk margin and equity risk. All of these adjustments should improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments.

Looking at about proportionality, which has always been an important element in Solvency II, there is certainly scope to increase its use. Our Opinion recommends a new process for applying and supervising the principle of proportionality. This includes clear risk-based quantitative criteria to identify low risk undertakings eligible for applying proportionality measures. These will capture not only the size but also the nature and complexity of the different risks and will provide legal certainty regarding the application of the proportionality principle. Undertakings complying with such criteria will be able, after a notification, to apply automatically a number of proportionality measures that – in the main – focus on governance and reporting.

Finally, we need to supplement the current micro prudential framework with the macroprudential perspective (including the introduction of specific tools and measures), as well as the need to develop a minimum harmonised recovery and resolution framework and achieve a minimum harmonisation in the field of insurance guarantee schemes.

Our Opinion does not change the fundamentals of the framework. Instead, we are proposing measures that we believe will keep the regime fit for purpose by the introduction of a balanced update of the regulatory framework, reflecting better the economic situation and completing the missing elements from the regulatory toolbox.

At the end of the day, Solvency II is here to protect the consumer. In our review, it was important for us not to lose sight of this fundamental objective. Our balanced approach ensures that policyholders will remain protected in these challenging times.

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