Moderates – Update

The Solvency II Directive has been reviewed in EU trilogue negotiations. The aim is not only to ensure the stability of insurance companies, but also to mobilise capital for the economic transition.

Translated from German – Initially published in Moderates Update

When the trilogue agreed on the Insurance Recovery and Resolution Directive, the European institutions also reached a political agreement on the shape of the Solvency II review at their meeting on 13 December 2023. “We are expecting the proposed amendments to the Directive in the first quarter of 2024. The effective date should be around 1 July 2026”, said Matthias Müller-Reichart, Professor of Risk Management at RheinMain University of Applied Sciences in Wiesbaden. From a regulatory perspective, the insurance industry tends to come after the banking sector, because the banks represent greater risks for the economy as a whole. “Since the financial crisis a wide range of capital market risks have been identified, above all in the banking industry. So numerous new regulations were adopted for the banks. Insurance regulation always comes later than banking regulation; Solvency II followed Basel II, and it’s the same with the respective revies”, explains Melanie Schlünder, auditor and actuary (DAV) and senior manager at PwC for Risk & Regulation.

“As an insurer you will find yourself in difficulties in future if you cannot prove that your investments improve your ESG profile.” Prof. Dr. Matthias Müller-Reichart, Professor for Risk Management at RheinMain University of Applied Sciences in Wiesbaden.

To optimise protection for insurance customers, the regulators want to ensure a solid framework and good supervision

No major surprises

The reason for amending the directive was not that there were serious defects in the fabric of Solvency II; it is simply part of a regular revision process. The changes made in the course of the trilogue negotiations are therefore not dramatic, but there are lots of them. “Since it was implemented, Solvency II has demonstrated that it is the gold standard for consumer protection. The current revision looked at the experience gained to date and opportunities for technical improvements”, explained a speaker from the association of Austrian insurance companies (VVO). But it is not all sweetness and light; there were and are very real reasons for tightening up the rule book. “The EIOPA has identified some insolvencies and near-misses among insurers and reinsurers in the EU. This is another reason for revisiting the Solvency II Directive, including a framework for recovery and resolution”, explains Schlünder. The problems at Italian life insurer Eurovita in 2023, for example, were due to liquidity issues resulting from large numbers of policy cancellations.

Interest rate risk

The directive primarily affects the insurer’s capital investments. As well as giving greater weight to sustainability risks, the regulator’s focus here was particularly on interest rate and equity risks. The changes therefore mainly relate to the interest rates used for measuring obligations to customers. “We can see two opposing effects here, which to a certain extent offset one another”, explains Jörg Asmussen, managing director of the German trade association for the insurance industry (GDV). Firstly, the interest rates for very long-running obligations will fluctuate more in future and generally be lower. As a rule, the interest rates will be derived from market rates. But because market values are no longer available in the necessary depth for very long-term maturities, an extrapolation model is used for these maturities that is based on a long-term convergent interest rate known as the “ultimate forward rate”. This model is being adjusted as part of the review: the ultimate forward rate, i.e. the

interest rate used to calculate the long-term risk-free yield curve for the measurement of technical provisions, gets a lower weighting, which makes the model more conservative. When insurers discount their obligations using a lower interest rate, the present value of their technical provisions goes up, which reduces their own funds. For the calculation of the solvency capital requirement in the standard model the intention is also, when interest rates are negative, to include the risk of even lower interest rates in future, which is a lesson learned from the phase of very low rates.

“Both changes particularly affect the German life insurers, because the average duration of liabilities is longer in Germany than in the other member states. Austria and France have long-term guarantees too, but just not as long as in Germany”, says Asmussen. Müller-Reichart explains the impact this can have on investments: “The new extrapolation method for the risk-free yield curve means that interest-bearing securities come under pressure. The result will be that companies are less willing to invest in interest-bearing securities.” It remains to be seen how strong this effect will be. When the review meetings were taking place, the interest rate for ten-year bunds was still at zero, but yields have since gone up. “So the effects could be less pronounced than originally thought.”

Volatility adjustment to interest rates

The proposed changes to what is known as the volatility adjustment are expected to have the opposite effect, because they will shift the yield curve upwards. The volatility adjustment is intended to reduce the effects on solvency of short-term swings on bond markets. In aggregate, the review reduces the discounts applied when calculating the volatility adjustment, which makes the yield curve a bit more attractive again for the insurers. “That is absolutely justified, because in contrast to the banks, the insurers do not have to be able to dispose of their investments at any time. Generally speaking, we hold our securities to maturity, so we can cope with any fluctuations in the interim”, says Asmussen. This situation has now been taken into account by refining the methodology slightly.

“There are also changes to the standard formula for interest rate risk. Here there was previously no shock for negative interest rates, but this is now being introduced in the revision of the Solvency framework”, explains Schlünder, before adding as reassurance: “But it is being phased in gradually. Insurers have to start applying the new shock mechanism over a transition period of five years.”

“We can live with all these adjustments for interest-bearing assets”, reckons Asmussen, “and companies can also adapt their business model to a new regulatory and economic environment.” Some points have not yet been defined in detail, however, and will only be finalised in the Level II and III reforms.

The proposed changes to the Solvency II Directive are expected in the first quarter of 2024. Initial application is likely to be from around 1 July 2026.

The review also contains changes for equities. The corridor of the symmetric adjustment for equity risk is being expanded from +/- ten to +/- 13 percentage points. Müller-Reichart explains this as follows: “Type I equities, so equities from issuers in OECD or EEA countries, are normally stressed at 39 per cent. Type II equities from issuers outside the OECD and EEA are stressed at 49 per cent.” The review maintains this basic stress test. “But the EIOPA will issue a monthly report on how the stress for equities has to be modified by the symmetric adjustment. The expansion gives the EIOPA the option of making greater use of the corridor in future. If it adjusts it downwards, it can incentivise insurers to invest more in equities.” The reason for expanding the corridor is that volatility on stock markets has increased and this should be reflected in the capital allocation.

“The changes to the symmetric adjustment for equities proposed in the review are not particularly important for German insurers”, avers Asmussen. The reason is again that they have a low capital allocation to equities.

Relaxant for long-term equity

A mini review of Solvency II took place in 2019. “Back then, in addition to the existing capital charges for Type I and II equities and the risk sub-module for qualifying infrastructure, another sub-module with lower capital requirements was introduced for long-term equity”, says Lutz Boxberger. The lawyer and tax adviser is a managing director at Golding Capital Partners, where he is responsible for Tax and Regulatory Affairs. He illustrates what this means: “Whereas normal equities have a shock of 39 or 49 per cent, insurers only have to shock long-term equity investments with 22 per cent and qualifying infrastructure with 30 or 36 per cent.” “German insurers have not benefited from the lower capital requirements for long-term equity to date.” Melanie Schlünder, Senior Manager, Risk & Regulation at PwC, auditor, actuary (DAV)

Schlünder explains what is at stake: “The regulator especially wanted to encourage long-term equity investments, and so insurers have to hold less solvency capital for them.” At the same time she points out that German insurers have not been able to make use of the advantages so far. “This is due to the German system of life insurance and the participation of policyholders. It is not compatible with the ringfencing that was previously required by the regulations (separate management of equities portfolios, no offsetting of gains and losses across portfolios). For this reason German insurers did not benefit from the lower capital charge for long-term equity. “In future the aim is to get away from the very strict ringfencing requirements, but here we will have to wait and see what the exact wording in the Level 2 rules is”, says Schlünder.

The mood at Golding is cautiously optimistic regarding the planned easing of requirements for the long-term equity sub-module in the final text of the directive. “The ringfencing that has been the obstacle to date could cease to apply in future”, says Boxberger. If the clear legal or contractual attachment of portfolios is no longer required by the directive or the implementation regulation, this could open up interesting structuring opportunities. “Expanding the geographical scope to OECD investments and the clarification that the eligibility criteria for this sub-module will be examined at the fund level, if it is an ELTIF, for instance, also encourage us to keep thinking about structuring options”, he confirms. The fund could be structured as an ELTIF in this case. “The review explicitly mentions the ELTIF as an eligible fund structure for institutional investors”, continues Boxberger. He hopes that this will enable his company, an alternative investment specialist, to grow its business with insurers.

Other EU countries have also not made much use of the exemptions for long-term equity investments. “The advantageous treatment of this new category of equity risk in Solvency II was introduced back in 2019, but the insurance sector has hardly used it”, observes Alberto Scarsini, Global Insurance Advisory Director, EMEA, at the asset manager Schroders. This, he explains, is “because the required eligibility criteria are seen as being too restrictive. We are waiting now for the technical details and are hoping for tangible simplifications in order to take advantage of this regulatory treatment of long-term equity investments and mobilise capital for the European sustainability targets”, says Scarsini.

The GDV is also cautiously optimistic on this point. “If we can make better use of the advantages for long-term equity in future, then that will be a positive for us. But we can only give a definitive opinion when the rules have been finalised”, says Asmussen, and quickly quells any expectations that insurance companies will start piling into equity investments. “Even advantages for long-term equity will not cause the equity allocation of German insurers to go from five to 50 per cent.”

Adjacent regulations

The Insurance Capital Standards (ICS) for international insurance groups and the IORP Directive are also getting a review

Regulators always like to keep on eye on what their colleagues are up to, so it is no surprise that the International Association of Insurance Supervisors (IAIS) is carrying out a review of the minimum standards for insurance groups with international operations. “In Germany the companies monitored by the IAIS include Allianz, Munich

Re and Talanx. The global Insurance Capital Standards (ICS) are due to be completed shortly. As expected, they will form part of the package of measures within what is known as the ComFrame", reports Müller-Reichart. ComFrame is short for Common Framework for the Supervision of Internationally Active Insurance Groups. For institutions of occupational retirement provision (IORP) there is a separate framework, the IORP Directive, which came into effect on 13 January 2017. The standards for IORP are also to be reviewed, in parallel with the rules for insurance companies. The EIOPA sent its proposal to the European Commission on 28 September 2023 and pension funds are now awaiting a review of the directive. According to PwC, the EIOPA feedback is over 250 pages long, including the annexes, which suggests that numerous amendments are planned.

Asset managers adapt to the review

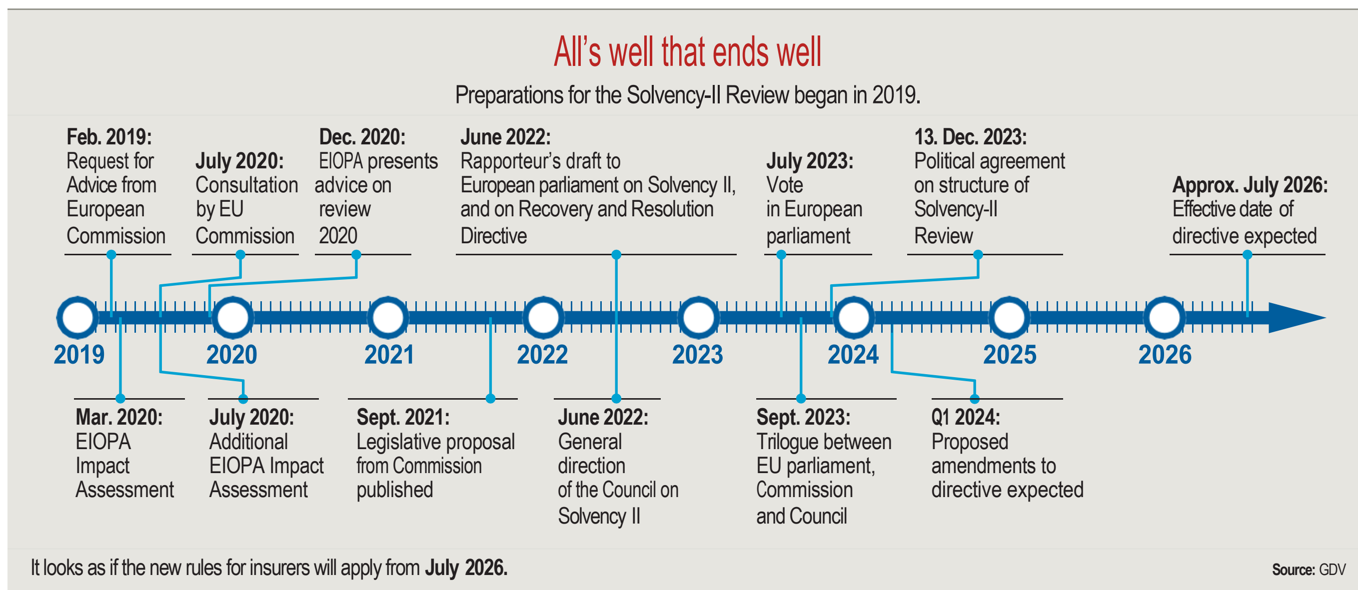
Asset managers are adapting the strategies they offer insurance companies to the Solvency II amendments. "The review means that the insurers' risk margins will go down, because the costs of capital are reduced from 6.0 to 4.75 per cent. If companies do not use the capital freed up in this way to increase distributions to shareholders or develop new products, they can invest more in private assets going forward; in infrastructure debt or equity, for instance", suggests Scarsini. That is of course what the regulator is aiming for: to steer more private capital towards the transformation of Europe into a sustainable economy.

"It would not be systematic to impose a capital charge for things that cannot be found in the data."
Jörg Asmussen, Managing Director, Gesamtverband der Deutschen Versicherungswirtschaft (GDV)

Scarsini points out that the regulator in the UK, which is no longer part of the EU following Brexit, is also moving in a similar direction. "In the UK the costs of capital are even being reduced from six to four per cent, and there too, the capital released is meant to be used for investments in a greener economy." The Solvency II review also includes sustainability elements. According to the rules that will soon apply, insurance undertakings will have to include ESG factors in their capital investment strategy as part of the Prudent Person Principle. "Until now they only had to consider ESG factors for their Own Risk and Solvency Assessment (ORSA), but in future they will also be part of the capital investment strategy", underlines Müller-Reichart, and adds: "The top-level regulator, i.e. the trilogue, was very keen that the European Green Deal should feature in the Solvency II review." This concept was presented by the European Commission in 2019 and aims to reduce net emissions of greenhouse gases in the EU to zero by 2050 and so make it the first continent to become climate neutral. As the insurance industry commands large pools of private capital, it is important to get them on board.

Plenty of wiggle room

In this area, however, the review is limited to a qualitative statement. There are no binding ratios, for allocations to Article 8 or Article 9 funds under the Disclosure Regulation for example, at least not yet.
"The requirement as formulated in the review is indeed relatively soft. But insurers will find themselves in a difficult argumentative position in future if they cannot show that their capital investments improve their ESG profile", says Müller-Reichart. The EU regulator wants to convince the insurance industry to invest more in environmental infrastructure. "I see what has been defined in the current review as the starting point. If the insurance sector does not demonstratively raise its game in this area, then the process will continue, maybe even with quotas for sustainable investments." Müller-Reichart advises insurers to take this sustainability focus seriously.
The sustainability trend is already visible in the ORSA. As of 2022 insurance companies have to calculate various scenarios for their climate-change exposure over the short and long term. "There is one scenario with a global temperature increase of below two degrees Celsius, and one for significantly more than two degrees Celsius. Now they are thinking about an extra capital charge for unsustainable investments", says Scarsini. "It didn't make it into the Solvency II review, but the European Commission has asked EIOPA to do some studies on the supervisory treatment of unsustainable investments and present its proposals."



The EIOPA consultation paper on this topic suggests that the capital requirements for equities and corporate bonds exposed to sustainability risks should be increased substantially, he says.

Guided by the data

Boxberger was hoping that the review itself would have taken a clearer position. "But unfortunately the review does not have either a green-supporting or a brown-penalising factor, which would have been very much in the spirit of the Green Deal and helped to channel investments in this direction", he regrets. Because almost all the funds his company manages qualify for Article 8 or 9, he would have liked to see preferential capital requirements for ESG-compliant investments.

However, GDV head Asmussen warns against jeopardising the basic principles of Solvency II with political wish lists. "In the Solvency II framework we should stick to things that are based on evidence and data. It would not be systematic to impose a capital charge for things that cannot be found in the data. That sort of thing doesn't belong in Pillar I of Solvency II, where capital requirements are determined, but at most in Pillar II, with the company's own risk assessment. We already have various analyses of climate scenarios there in the ORSA." Because the ORSA process analyses the entity's own strategy and risk assessment it is also the right place for climate risks, to ensure that the investor does not end up with stranded assets.

He does acknowledge the dilemma, however: "Of course the data-based approach in Pillar I works with data and distributions from the past. The problem with climate change is that the risks may only now be making their way into the data but are not visible in the historic figures." That is a challenge, he admits. "The EIOPA has found indications of higher transaction risks for fossil fuels, which may be transferable. But we do not see sufficient evidence here for changing the standard model. In any case, an impact assessment shows very clearly that it would not affect the coverage of policyholders or financial stability", says Asmussen. Scarsini points to the situation abroad: "Climate scenarios are an important topic for all insurance regulators – not only in the EU, but also in the UK, Bermuda and the USA. Several stress tests have been carried out in the UK in recent years to model the impact of climate change on the insurance industry, and the idea of including climate risk in the capital framework or penalising unsustainable investments directly with an extra capital charge has not become accepted so far."

Securitisations

The EU regulator also looks at the spread risk for securitisations. "The spreads for securitisations have got wider

in recent years. This represents a liquidity risk for investors that is now being examined, explains Müller-Reichart. It has not had an impact yet but could have consequences for capital investments in future.

Looking at the broader category of spread products, Scarsini makes the general point that, “in recent years there have been several shocks on financial markets that have resulted in greater volatility in the spreads for credit products. The aim is to immunise portfolios better against spread changes, for example by using the volatility adjustment mechanism more effectively to stabilise insurers’ balance sheets.” He believes that insurers should still be allowed to invest in spread products. “Used in the right way, they can also contribute to the EU sustainability goals. Investments in private assets and liquid instruments could be expanded – naturally on condition that everything is up to scratch in asset/liability and liquidity management.”

Asmussen is relaxed when it comes to securitisations: “There is a lot of talk about securitisations, but they do not currently play a big role for us in terms of investments.”

No return to full guarantees

The review increases the pressure on long-term guarantees as they are used in the life insurance business. The question is how this will affect the insurers’ business models. “The pressure is coming from the classic guarantee, where the guaranteed interest rate over the whole life of the policy has been up to 4.0 per cent”, explains Müller-Reichart. The highest rate for new policies is currently 0.25 per cent, but the German Association of Actuaries (DAV) has recommended raising the guaranteed rate to 1.0 per cent in view of the steep rise in interest rates. If the Federal Finance Ministry approves the recommendation, it would be the first time for 30 years that the maximum interest rate had been raised.

During the period of low interest rates the life insurers moved away from long-term fixed guarantees, largely offering hybrid policies for new business or completely fund-based contracts that have no guarantee at all. The question is whether this trend will persist now that interest rates have risen again. The regulator is insisting on a greater weighting for sustainability factors – not only in the ORSA, but now also for capital investments.

I can’t see any return to classic guarantees”, opines Müller-Reichart. Asmussen sees things similarly: “The insurers will continue to model and price the guarantees as always, because they represent a risk for us. I don’t see any particular stimulus for our business model coming from the review. It comes more from the capital markets and of course from our customers”, says the GDV head.

In the trilogue negotiations there was agreement that the Solvency and Financial Condition Report (SFCR) should be addressed to a wider public. It will therefore be split in two: one SFCR for the general public and one for professionals. “The report for the general public can now be highly simplified. A two or three-pager should basically do it”, explains Müller-Reichart.

“The ringfencing that has hitherto been an obstacle could cease to apply in future.”
Lutz Boxberger, lawyer and tax adviser, responsible for Tax & Regulation at Golding Capital Partners

The SFCR for a professional audience will remain more detailed and is even to be expanded with the addition of sustainability reporting.

“There are changes to the quantitative reporting templates (QRT). Quantitative disclosures have to be made on sustainability risks in the investment portfolio here too in future, starting with the reporting year 2023”, says Schlünder. She points out that QRT requirements can be altered relatively quickly by the European Commission, without any need for trilogue negotiations.

The industry certainly anticipates further requirements ahead. “Any inclusion of additional sustainability elements,

which is currently under evaluation, should be risk-based and evidence-based. The overall impact of the review will be to increase the operational workload and the volume of reporting, which unfortunately contradicts the European Commission's announcements and plans to reduce the reporting burden for companies by 25 per cent", says a spokesperson for the VVO. Schlünder plays down the extra demands: "Lots of the data has to be collected anyway, for the ORSA, for instance." Macroprudential risks, ESG and liquidity risks all have to be disclosed there. "The regulator will be looking at these more closely in future, especially the liquidity risks", says Schlünder.

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Proportionality principle

The regulatory demands have been expanded in various areas in recent years, which constitutes a significant burden, especially for small and medium insurance companies. The principle of proportionality has been revised in the course of the review as a result. There is now a clearer definition of small and low-risk-profile undertakings, and the thresholds have been raised. Insurance companies previously qualified as "small" when their annual gross written premiums did not exceed €5 million, and their technical provisions were not higher than €25 million. In the review the limits were raised to €15 million in gross written premiums and €50 million in technical provisions. "This means some of the smaller businesses are no longer subject to Solvency II at all. Things will be significantly easier for them in future, because they only have to comply with Solvency I", says Müller-Reichert. "In addition, the clarifications mean that every company knows immediately whether or not it counts as a 'small and non-complex' insurance undertaking with reduced regulatory requirements.

Schlünder regrets the lack of an additional focus on the basics: "All they did in the review was to change the entry criteria. It would have been better if they had seen proportionality more as a tool, to have more latitude within the requirements."

In Austria the industry is happier with the changes: "We welcome the efforts to put the principle of proportionality on a stronger footing – this should reduce excessive burdens for small and non-complex insurance undertakings", says the spokesperson for the Austrian Association of Insurance Companies.

At the German trade association, by contrast, the proportionality rules do not go far enough. "We would have preferred the thresholds to be higher. And the small insurance markets benefit more than the big ones", criticises Asmussen. "In Malta there will be fewer insurers that count as large than in France or Germany. We would have liked to see a bolder approach."

Positive bottom line

Overall, the industry is not unhappy with the update to Solvency II. "German insurers were not satisfied with the first drafts of the review. But stakeholders have put a lot of work into the regulatory process and the industry can now live with the results of the review", reckons Schlünder. Müller-Reichart sums it up as follows: "The Solvency II review has brought some useful rectifications, adjustments to risk methodologies and clarification of some concepts that were previously rather fuzzy, like the principle of proportionality. Greater use can now be made of volatility. This reduces pressure and releases capital, which the insurers can now invest in the necessary digital and sustainable transformation – at least that is the regulator's intention."